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ABSTRACT

Written with the small business manager and first-time entrepreneur in mind, this book provides the adult learner, in a class or alone, with activities and questions to increase understanding. These are intended to aid decision making as plans are made for the chosen enterprise. The book is divided into five parts: Looking at Entrepreneurship, Planning for Entrepreneurship, Marketing Your Product or Service, Financial Management, and Managing Small Business. Key concepts are given at the beginning of each chapter, along with the goals or objectives for the chapter. Most key concepts appear only in the first chapter in which they are used. Case studies are used to illustrate the issues and problems discussed in each chapter. Names have been changed in these true stories and the locations fictionalized to protect the identities. Appendixes provide a sample partnership agreement, sample articles of incorporation, applicable federal income tax forms, a glossary, and index. (YLB)

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Small Business Planning and Management for the First-Time Entrepreneur

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PREFACE

This book was written with the small business manager and first-time entrepreneur in mind. The "how to's" are emphasized in easy to read language. Simplicity is crucial to the small business manager or fledgling entrepreneur. As you know, there are only three basic colors, seven musical notes, and ten digits. It is how we put these together that makes a masterpiece. The authors' ultimate goal is to simplify the concepts that must be mastered.

Additional references are given to provide more information as the reader advances. Many specialized business texts are detailed in the final chapter. We recommend these to you.

The adult learner, in a class or alone, and self-paced, is provided with activities and questions to increase understanding. These can aid in decision making as plans are made for the chosen enterprise. The book is divided into five parts:

I Looking at Entrepreneurship

II Planning for Entrepreneurship

III Marketing Your Product or Service

IV Financial Management

V Managing Small Business

Key concepts are given at the beginning of each chapter, along with the goals or objectives for the chapter. These definitions apply only to this text and are not Webster's. Most key concepts appear only in the first chapter in which they are used. A glossary is provided for further reference and includes all the key concepts.

Case studies are used to illustrate the issues and problems discussed in each chapter. These are true stories, but the names have been changed and locations fictionalized to protect the identities. The "Corner Bakery Accounts" are used with the owners' permission.

Appendices provide a sample partnership agreement, a sample articles of incorporation, and a checklist for incorporation. These provide the reader with some basic examples to study while planning for his or her business start-up.

In addition, a workbook and instructor's manual are available to accompany the use of this text.

D. Howard Doster

Donald F. Connelly

William H. Hamilton

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PART I

Looking at Entrepreneurship

CHAPTER 1

Start Where You Are

CHAPTER GOALS

- To help spark the entrepreneurial spirit.
- To identify your three business resources.
- To help you measure your resources.
- To identify the purpose of a balance sheet and an income statement.
- To identify the relationships among the balance sheet, income statement, and cash flow budget.

KEY CONCEPTS

Balance sheet – A financial report summarizing a business' financial condition categorized by assets, liabilities, and the owner's equity at a given point in time.

Basic accounting equation – Assets minus liabilities equals net worth *or* assets equals liabilities plus net worth.

Business – An entity created, organized, and conducted to make a profit.

Capital – Money invested in the business.

Cash flow – The difference between cash coming into and going out of a business enterprise over a certain time period.

Chamber of Commerce – Nonprofit entity designed to promote local community activities and business.

Competitive advantage – Lower cost, higher quality, or other advantage over the competition.

Cost – The money you pay for materials, labor hired, money borrowed, and overhead expenses to make the product you sell in your business.

Counseling – One-on-one advice to small business owners.

Debt financing – Borrowing money to operate or to purchase equipment.

Entity – Something that exists independently.

Equity financing – Money provided by owners that has not been loaned to a business.

Entrepreneur – One who takes the risks of starting and operating a business.

Event – A change within the business, such as completing goods for sale.

Finance – The money invested in, or used and earned by a business.

Financial statement – Collection of financial reports consisting of at least a balance sheet and income statement, but often including a cash flow statement and sometimes detailed notes and other descriptive comments.

Income statement – A financial report showing revenues, costs and expenses, and profit over a period of time.

Low-cost producers – Producers who have lower material, labor, and overhead costs of production.

Management – Business decision making.

Marketing – Activities to sell the product or service offered.

Mind resources – The knowledge you bring to an enterprise.

Money resources – Finances available for a business venture.

Muscle resources – The time you can devote to an enterprise.

Operations – The day-to-day activities of the business.

Performance – Effective function with quality of work done.

Personnel – The people who work in the business.

Profit – The money you earn when you sell products for more than their cost to you.

Ratios – Financial measures used by lenders in decision making.

Recipes – The way resources are used in the business (formulas).

Resources – Mind, muscle, and money one can use for a business enterprise.

Small Business Administration (SBA) – Federal agency devoted to the interests of small businesses.

Small Business Development Centers (SBDC's) – Public/private partnerships to promote small businesses.

Transaction – Financial exchange between entities.

CASE STUDY

Beth Buys a Bakery

Beth Muehlhausen had worked at the Corner Bakery longer than the owner had owned the **business**. She had two college-age children and two in high school. Their help made the idea of buying the Corner Bakery attractive when the owner decided to move to another city.

Jamie, one of Beth's friends, encouraged her to become the new owner. Because of Jamie's experience with the local **Small Business Development Center** (SBDC), she persuaded Beth to seek their **counseling** services.

Beth found their help beneficial as they critiqued her business plan. They helped her develop a two-year **cash flow** forecast. The business plan included the projected expansion of the specialty cakes and catering services.

The Small Business Development Centers are public and private partnerships sponsored by the **U. S. Small Business Administration** (SBA). In different states sponsorship varies from the **Chamber of Commerce** to universities. Their purpose is to aid development of small businesses through seminars, workshops, information, counseling, and start-up loans from the Small Business Administration.

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Beth and her husband, Fritz, applied for a loan with their local bank. After reviewing their balance sheet, income statement projections, and cash flow forecast, the bank asked for a second mortgage on their home in order to secure the loan needed to purchase and operate the Corner Bakery.

Beth knew the business and she had earned the trust of her customers. Her transition into ownership was exceptionally smooth and she had no downtime nor loss of business.

Notes from the Case Study

1. Knowledge of the industry and specific business is important to success.
2. Bankers often require personal assets, such as a second mortgage, as collateral for business start-up loans.
3. Risk-takers have no guarantees.
4. Would-be entrepreneurs can benefit from SBDC counseling.
5. Bankers are excellent resources for financial planning.
6. Family labor is often a helpful resource.
7. A change in ownership often disrupts business activities.
8. Realistic cash flow forecasts are essential to acquiring capital.
9. Customer loyalty is a valuable business asset.
10. SBDC offices provide free services such as printed materials, workshops, seminars, and counseling.
11. Lenders require a balance sheet and income statement projections prior to loan approval.

STARTING A BUSINESS

Start Where You Are

Question: Where do I start planning for my business?

Answer: You start at

You inventory your resources that can be applied to the new business.

What are your resources? We each have "mind," "muscle," and "money" resources that can be applied to a business venture as we seek to become entrepreneurs. To illustrate this concept let's look at the following list of Beth's resources:

Mind

1. Experience at the Corner Bakery
2. Help from a friend who is a banker
3. SBDC counseling aid
4. Husband's help and expertise

Muscle

1. Own time
2. Two high school children
3. Two college-age children
4. Husband's part-time help
5. One exceptional employee

Money

1. Family savings
2. Second mortgage on the family home

The triangle in Figure 1-1 represents the relationship of the mind, muscle, and money resources.

How can we measure our resources? We can take stock of our knowledge and the advice available to us in our community as mind resources. Next, we can follow the activity discussed in Chapter 3 on goal setting to inventory our personal muscle resources. We can also identify the family help that will be available to a business enterprise.

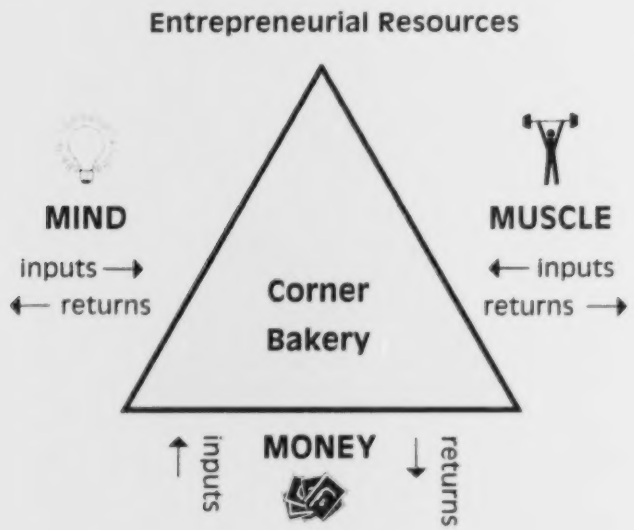

Figure 1-1 The entrepreneurial resources for the Corner Bakery

To inventory our money resources we need to complete a personal financial statement such as the one in Figure 1-2.

The **basic accounting equation** is illustrated in the financial statement:

Assets - Liabilities = Net Worth, *or*

Assets = Liabilities + Net Worth

My Personal Financial Statement

Date _____ 19 _____

Name and Address _____

_____

_____

This is a true, accurate, and complete statement of my financial condition as of the above date.

_____

Signature

MY BALANCE STATEMENT AS OF _____ (date)

Assets (What I Own) *(Itemize in lists on back of page)*		**Liabilities (What I Owe)** *(Itemize in lists on back of page)*	
1. Cash, checking, savings (list A)	$ _____	11. Accounts payable	$ _____
2. Government securities, stocks, bonds, etc. (list B)	_____	12. Notes to financial institutions (list F)	_____
3. Life insurance (cash value) (list C)	_____	13. Notes to others (list G)	_____
4. Accounts and notes receivable	_____	14. Real estate mortgage loans (list H)	_____
5. Salable inventory	_____	15. Interest and taxes due	_____
6. Real property (list D)	_____	16. Other debts	_____
7. Machinery and equipment	_____	**TOTAL LIABILITIES**	$ _____
8. Furniture and fixtures	_____	17. **OWNER'S EQUITY** (total assets less total liabilities)	$ _____
9. Motor vehicles	_____		
10. Other property (list E)	_____		
TOTAL ASSETS	$ _____	**TOTAL LIABILITIES AND EQUITY**	$ _____

Use appraised or estimated fair market values and note all assets which secure debts.

MY INCOME STATEMENT FOR THE PERIOD ____ TO ____

Statement of Income	**Prior Year**	**Current Year**
Net income from my proprietorship business	$	$
Salaries, wages, etc. from employment	$	$
Income from dividends and interest		
Net income from rent and other investments		
TOTAL INCOME	$	$

Figure 1-2 My personal financial statement *(continued on next page)*

Supporting Lists

(Total in each of the lists should agree with appropriate items on the financial statement)

LIST A – Checking and Savings Accounts and Certificates of Deposit

Name of Depository	In Whose Name	Amount
	TOTAL	$

LIST B – Securities

Description	Marketability	Number of Shares or Principal	Registered in Name of	Current Value
			TOTAL	$

LIST C – Life Insurance

Company	Insured	Beneficiary	Face Amount	Loans	Cash Value
				TOTAL	$

LIST D – Real Property

Description (Acreage and Location)	Title in Name of	When Acquired	Cost	Insurance	Current Value
				TOTAL	$

LIST E – Other Property

Description	Value
TOTAL	$

LIST F – Notes to Financial Institutions

Creditor	Security	Date Due or Payment Schedule	Amount
		TOTAL	$

LIST G – Notes to Others

Creditor	Security	Date Due or Payment Schedule	Amount
		TOTAL	$

LIST H – Real Estate Mortgages

Creditor	Property	Date Due	Amount
		TOTAL	$

Use additional sheets, as necessary, to complete or for more lists.

Figure 1-2 My personal financial statement *(continued)*

The purpose of the balance sheet is to give you a financial snapshot of the individual or business entity at a given point in time. The banker uses the balance sheet to identify assets adequate to secure a loan. The income statement, or profit and loss statement, shows what happens between the times when balance sheets are completed. The banker uses the income statement and the cash flow forecast to help estimate the borrower's repayment capacity.

The income statement is also sometimes called the operating statement, or the P & L (Profit and Loss Statement). It summarizes the revenues, expenses, taxes, and other financial items for a given length of time, such as a year.

Schedule C (Form 1040) can be completed from an income statement for the tax year. A Schedule C Form 1040 appears as Appendix D. The income statement cannot give a complete picture of the condition of the business. Just as the balance sheet does not give operating information. Both reports are needed to compute ratios used by financial institutions granting credit. The relationship may be expressed as in Figure 1-3.

The Relationship between Balance Sheets and Income Statements

BALANCE SHEET ON 12/31/X3			BALANCE SHEET ON 12/31/X4	
Assets	Liabilities		Assets	Liabilities
	Net Worth			Net Worth
		(CHANGE)		
		NET INCOME (OR LOSS)		

Figure 1-3 Relationship between balance sheets and income statements

Figure 1-4 shows the relationship among the balance sheets, income statements, and cash flow statements.

Management may be defined as "using what you now have to get what you now want most." No one wants to waste resources. Yet, with about the same resources, some persons gain more returns. We say they are better managers. Better managers do better things or do things better, some even do both!

Relationship among Balance Sheets, Income Statements, and Cash Flow Statements

BALANCE SHEET ON 12/31/X3			BALANCE SHEET ON 12/31/X4	
Assets	Liabilities		Assets	Liabilities
CASH			CASH	
		(CHANGE)		
		NET CASH FLOW		
		↑		
		± Change in certain balance sheet items		
		↑		
		± Adjustments for noncash transactions		
		↑		
	Net Worth			Net Worth
		(CHANGE)		
		NET INCOME (OR LOSS)		

Figure 1-4 Relationship among balance sheets, income statements, and cash flow statements

Figure 1-5 The four components of management

Business management includes four areas: **operations**, **marketing**, **finance**, and **personnel** as illustrated in Figure 1-5. Business success is affected by one's performance in each of these areas. We have looked in detail at the financial area. A brief discussion of each area and the management decisions involved follows.

1. **Operations** at the Corner Bakery include mixing, baking, and packaging each product line offered. Management decisions involve which recipes to use, what quantity to bake daily, which employee to assign to each task, when to purchase raw materials, and similar tasks.

2. **Marketing** decisions involve market research, promotion, advertising, merchandising, pricing, displaying, and selling. The Corner Bakery may have the best chocolate chip cookies in the area, but unless they are brought to the public's attention and the public buys them, efficient production operations will not make a profit. By the same reasoning, if the product lacks quality or appeal, marketing cannot insure a profit.

   Marketing management decisions include who to target, which media to use for advertising, when to advertise, what packaging to use, and similar items.

3. **Finance** is often a critical factor in a new business enterprise. Being able to get enough capital often contributes to one's ability to establish and sustain the needed **competitive advantage** of a business. **Equity** versus **debt financing**, refers to the following decisions:
   a. How much money should be obtained from the entrepreneurs?
   b. How much should be obtained from partners or stockholders?
   c. How much should be borrowed?

   Accounting practices, and the decision regarding extension of credit to the bakery's customers are other management decisions in the financial area.

4. **Personnel** are critical to success. Friendly, helpful people can enhance the business; surly, disrespectful employees turn customers away. Management decisions in this area include when to seek employees, what application process to use, company policies regarding work schedules, compensation, and whether or when to allow employees to become part owners of the business.

Management Decisions Are Not Set in Concrete

We are committed to a management decision we make for only the time period between then and the next time we change it. For example, the recipe we used for the chocolate chip cookies yesterday may have resulted in cookies that contained too much shortening. So we change the recipe slightly to improve the cookies. We must understand how cookies are baked so we can predict how they should look and taste. We can change the recipe, oven temperature, or baking time as needed to improve the cookies.

The new information – cookie quality – alerted us to the need to change our management decision on the cookie recipe. The commitment to yesterday's plan is modified with the new information received. (In this case it was observed.)

COMPETING IN YOUR INDUSTRY

Identify Your Place in the Industry

Just as we used the idea of the change in the cookie recipe illustration above, the management of a bakery, or any business, uses recipes. **Recipes** are kinds and amounts of goods to make, source and quality of ingredients, advertising to use, location of the business, and all the many other elements that go into the successful operation of a business.

As I start where I am,
I try to
learn, know, ***understand*** *how my business operates*
so I can
predict *how it should look*
so I can
change *recipes when the cookies crumble.*

In a bakery operation, rewards vary greatly because of decisions bakers make and the differences in how they do jobs. Picking the right product mix, equipment type and size, ingredients, and baking recipes are important decisions. Once these decisions are made there are still big differences in the way bakers perform. Even with the same recipes, some bakers' cookies look and taste better than others.

Rate Your Performance

How do you rate your **performance**? As the operator of the Corner Bakery, how does your business compare to others in your area or state? Where do customers and lenders perceive you to be? Correctly estimating your own performance potential is perhaps the single most important management skill.

An excellent source for comparing your business performance to that of others is usually available from your banker. Robert Morris Associates, Philadelphia, publishes *Annual Statement Studies*. Organized by industries, the data includes ratios used in the industry.

A likely conclusion about production performance is this: in most areas there is more difference in production performance between bakers than there is in expected performance between product mix, equipment types, or ingredient recipes. Some persons just perform better than others!

Of course, some operators are able to change their business recipes more readily and successfully than others. The fact that you are reading this book indicates you are interested in looking for new, more profitable business recipes and in learning how to change your performance!

Note that the above discussion of performance does not relate specifically to persons identified as business entrepreneurs. The performance evaluation applies to everyone.

THE ENTREPRENEURIAL ATTITUDE

I Have an Idea!

"I have an idea!" Does that phrase excite you? Do you ever look at something and suddenly get an impulse to change things? There is a spark of creative genius in each of us. Being able to express it is what makes some artists great. Some scientists, surgeons, politicians, engineers, salespeople, bricklayers, farmers, and bakers also excel in their chosen profession because of this inner drive. In large businesses, it's what helps some employees progress to top management positions. Sometimes individuals decide to become risk-takers as they start their own businesses.

Three hundred years ago, early economists recognized this essential ingredient as the spark that caused some persons to dare to start and develop new business ventures. They adopted a French name to describe it – **entrepreneurship**.

Artists must learn to mix paints and design perspective and many other skills in order to express themselves fully through their work. Entrepreneurs are much more likely to succeed if they learn and use business skills.

In our country, we cherish the opportunity to take a chance, to be one's own boss, to start a new business. Experiencing this opportunity has excited people here since the first settlers came to our land. It's one of the biggest reasons for our present way of life. Entrepreneurial opportunities are great for people who want to develop a full-time, part-time, or pastime business or hobby.

The Entrepreneurial Attitude from "Make Your Own" to a Market Economy

Long ago people learned that they could be happier or better off if they helped each other. One way they helped each other was to discover they increased their productivity if they specialized. They made only one or a few types of things and then traded what they made to someone else. Of course, two people traded only if each person wanted what the other person made. They traded only if they both felt they were better off after the trade than before.

Sometimes people waited a long time before someone wanted their products. If no one ever wanted to trade for these products, they had a tough choice to make. For example: they lowered their prices, used the products themselves, kept them – or if the products spoiled – discarded them. Even though people were skilled at making something, if they couldn't trade the product to someone else, or if they couldn't exchange it for things they needed or wanted – they quit making the product.

Eventually, some people became specialized traders. These intermediaries found they could provide a useful service. While other people concentrated on changing the form of resources and making new products, these specialized traders concentrated on finding people who wanted their products and were willing and able to trade something for them. Their service included holding products for a time, moving them to another location, and advertising why people should want these products. As traders learned how to perform these services, they found they could carry the products between people who made them, promote the features of the product, perform the trade, and have some product left for themselves. Then, they could trade for other things or use them for themselves. Traders discovered they could survive and be successful in the trading business.

In today's terms, we say the traders performed the value-adding functions of utility: time, place, and/or possession. The makers performed the first type of utility as they changed the form from raw materials to a finished product.

This **barter** system was cumbersome, and trading was often hard and dangerous work. Consider the life of those people who traded with the Indians two hundred years ago. Trading became much easier as communication and transportation improved, as laws were agreed upon, and as money became the medium of exchange. Money became useful in two ways. Traders carried money and exchanged it for products that people grew or made. People then kept the money awhile before exchanging it for things they needed. Money became a useful medium of exchange and a useful store of value.

As trading became easier, the number of traders increased. They competed more with each other to provide their services. The traders who performed needed services at the lowest cost became successful. Others barely survived and some changed to other businesses.

Today, people still perform these same processes in marketing goods and services. Now people specialize even more and make fewer products for their own use and trade for more products and services. **Low-cost producers** and low-cost service providers thrive in this environment.

Industries such as automobiles and railroads, and utilities such as telephone, electricity, or the mail service can realize low cost only by large volumes. In other industries a start-up entrepreneur can gain a competitive advantage and may be able to sustain it. Examples include the businesses included as case studies in this manual.

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6. Texas A & M University, Instructional Materials Service. College Station, TX. Has a series of management help publications for the beginning entrepreneur.
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FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Visit a business person you know and ask to observe operations. Identify the operations and management decisions relating to operations for a limited time period.
2. Do the same for the three remaining areas of management.
3. Using the data and forms supplied by your instructor, complete a balance sheet.
4. Using the data and forms supplied by your instructor, complete a P & L statement and a Schedule C (Form 1040).

Activities to Aid Decision Making

1. Interview the owner of a business and ask questions concerning how management decisions are made and what information is helpful in making those decisions. Some sample questions follow:
   a. How much is your building rent?
   b. How much working capital does it take to operate?
   c. How do you decide the amount of inventory to carry?
   d. How do you decide when another employee will be profitable?
   e. How much money does your inventory require?
2. Look up the Robert Morris Associates information for your business.

Questions to Increase Your Understanding of the Text

1. What were Beth's **competitive advantages** in her purchase of the Corner Bakery?
2. How can Beth sustain her competitive advantage?
3. Where does one have to start in planning?
4. What are the four management areas listed?
5. What will cause management decisions to change?
6. Why is the ability to rate your potential so important?

Questions to Aid Decision Making

1. What are my special management skills?
2. Where can I learn skills I need but do not possess?
3. How can I hire the skills I need but do not possess?

CHAPTER 2

The Idea of Entrepreneurship

CHAPTER GOALS

- To further develop your idea of entrepreneurship.
- To examine the advantages of working for yourself or someone else.
- To examine the characteristics of entrepreneurs.
- To examine your entrepreneurial characteristics.

KEY CONCEPTS

Business ethics - Standard of conduct for operating the business.

Conviction - Being certain of the right.

Pink slip - Termination of employment.

Products - Something grown, processed, or manufactured.

Profit - Income above all expenses.

Research - Systematic gathering of information for a specific purpose.

Resources - Labor, management, and materials used in production. Mind, muscle, and money are our entrepreneurial resources.

Restructure - Today many businesses are restructuring by downsizing and reducing employee numbers.

Services - Providing the use of something for others.

Vested - Having met the requirements for permanent participation in the plan.

CASE STUDIES

Ting Mi Makes Waves

Ting Mi had worked for her insurance company for a dozen years with excellent performance reviews and regular advances in pay and responsibilities. The extreme competitiveness of the industry was causing company management major concern and they decided to **restructure**. In the process many of the mid-level employees were left with a great deal of insecurity and doubts as to their future with the company.

Since Ting Mi had not been offered a job under the new structure, she updated her resume and interviewed with one of the company's major competitors. When the offer by the competitor was made, her company matched the offer and retained Ting Mi's services. Others in the same job classification left when they obtained other employment.

Ting Mi was later informed by her supervisor that he thought it was a strategy of the management for reducing their work force. She believed she was retained because she was already **vested** in the pension plan, while those who left were not yet fully vested in the plan. (The American Academy of Actuaries reports that in the past 10 years up to 10 million workers have lost their pensions.)

Sayyed Gets the Pink Slip

Sayyed was a young, energetic worker at the Firebrand Company plant in his city. They manufactured auto parts for a nearby assembly plant. When American automobile sales dropped, layoffs were common. As one of the least senior employees, Sayyed soon joined the growing list of unemployed workers.

His wages were excellent and Sayyed had been saving money as a safety net. His interest in wood working led him to build small rocking horses, bird houses, toy cars, trucks, and fire engines as an interim-income producer while waiting for the call back to the auto parts factory. The quality and popularity of his wooden toys kept him from considering the call back when it came. Sayyed became an independent business person without really thinking about it.

Notes from the Case Studies

1. Companies often have little loyalty to employees.
2. One should keep a current resume.
3. The days of working for one company during one's entire career are limited.
4. Working for others does not always provide job security.
5. Willingness to change jobs may improve your working conditions.
6. Some companies use uncertainty as a management tool.
7. Great performance reviews are not directly related to job security.
8. One should always prepare a reserve for bad times.
9. A hobby may become a business.
10. Quality is always important.
11. You start where you are.
12. Single-product businesses are economically volatile.

ENTREPRENEURSHIP AS AN ALTERNATIVE

Today's Pink Slips

Many "white collar" workers have seen the **pink slip** during times of takeovers, downsizing, restructuring, business failures, movement of jobs "off shore," and other causes. These workers often find the job search lengthy and frustrating. Entrepreneurship may become an attractive alternative.

As the case studies illustrate, job security is no longer the norm. Some people faced with the sudden change decide to try self-employment. A longtime dream of becoming their own boss is spurred on by the change in employment status.

Many people need a push to change an otherwise comfortable situation. Today's pink slip often triggers the plunge into a personal business. For some individuals, a strong dream is the motivation to start a business. Other people accumulate the knowledge, skill, or capital and then start a business.

No More Bosses or Pink Slips

One of the advantages of entrepreneurship is the opportunity to become *independent* and one's own boss. Often listed as advantages in becoming an entrepreneur are the following:

1. Entrepreneurship provides independence in making decisions.
2. You have the chance to try out your better ways.
3. You have the opportunity to set your own hours.
4. The **profits** (or losses) are all yours.
5. You are the boss.
6. You set your company policy.
7. You determine the products or services offered.
8. You are the problem solver.
9. You control the business' reputation.
10. You employ any needed help.
11. You discharge incompetent workers.
12. You set prices.
13. You have no office politics to worry about.
14. Your decisions affect your life.
15. You get to turn out the lights!

Add your own advantages to the list. Also write a separate list identifying the disadvantages. For example, the list could begin with big financial risks and long work hours. Each person decides the importance of each item on his/her lists when making the decision to become an entrepreneur. Each one of us has our own factors that affect the final decision.

The Courage to Try, or Try Again

Entrepreneurship requires courage! Courage is needed to risk the start of a business enterprise. Courage is needed for business decision making and for the continuing maintenance of a high standard of **business ethics**. Courage is especially needed for the second, third, or whatever number try that succeeds. Do you know how many times Babe Ruth struck out before he hit 714 home runs? Answer: 1,330.

Courage most often comes with **conviction**. When you are convinced that you have the better idea, you are able to act on that conviction with courage and determination.

Finding My Potential Opportunity for Entrepreneurship

If each of us is to find our best opportunity for successful entrepreneurship, we need to take inventory of our personal **resources**. We can start by answering a few pointed questions:

1. Do I make decisions easily without doubting?
2. Do I act on decisions vigorously?
3. What are my favorite activities?
4. Do any of these offer a good business opportunity?
5. Do I relish the challenge of a problem?
6. Do I work tirelessly at a challenge?
7. Do I take charge in a committee meeting that seems to be going nowhere?
8. If I am sure I am right, do the opinions of others matter greatly?
9. Can I work long hours and weekends to see my dream become reality?
10. Am I impatient with indecision on the part of others?
11. Am I sure I can do a better job?
12. Do I like working with people?

How you answered each question is of less importance than the overall weight of the total. Successful entrepreneurs tend to be positive on the majority of these items. Also recognize that some of the most successful businesses of all sizes are run by persons who do not rate high as entrepreneurs on these types of questions.

What Entrepreneurs Are Made Of

Among the many traits of successful entrepreneurs, the following characteristics are prominent:

1. *A Sense of Urgency* – Their big idea is all-important; they are anxious to be working on their superior way of conducting the activity.
2. *Commitment* – They believe in themselves and their ideas and are not easily affected by pessimistic forecasters.
3. *Confidence* – They know that they know! Most entrepreneurs are self-confident and believe in their ideas.
4. *Emotional Stability* – They are not given to wide mood swings – high one moment and low another.
5. *Energetic* – They have high energy and generally good health, they just don't have time to be sick.
6. *Flexibility* – If the first method or idea doesn't work, they are ready to try another until the difficulty is overcome.
7. *Independent* – Entrepreneurs think they can do the job better than anyone else. They like to be in control of their own destiny.
8. *Intense* – They concentrate on their ideas and how to implement them. Sometimes they are accused of having a one-track mind.

9. *Low Need for Status* – Entrepreneurs are not overly concerned with the opinions of others. Their self-confidence is sufficient to carry them through in spite of public opinion.
10. *Motivated* – The confidence in their own abilities and the conviction of the idea's worth keep them motivated and working.
11. *Optimistic* – They are optimistic in their outlook, things are great and are only going to get better.
12. *Organized* – We may not recognize it, but they have a logically (at least to them) organized system of their own.
13. *Persistent* – Success may mean that 5 o'clock provides, not quitting time, but a chance for uninterrupted work.
14. *Problem Solving* – They like the challenge provided by problems or road blocks on the road to success.
15. *Risks* – Entrepreneurs are willing to risk their own abilities, because they think that their knowledge and skills reduce risk to almost nothing.
16. *Vision* – They can see the big picture and keep all the parts of the enterprise and their inner relationships to each other in view.

What Entrepreneurs Do

Businesses provide **products** or **services** used by people. Ting Mi's company was a service company, but Sayyed's company made a product.

Products can be described as grown, manufactured, or processed. Farmers grow livestock and crops. Factories make toys, automobiles, soap and thousands of other items we use every day. Processors take a product and change it into another marketable product or products such as a dairy processing milk into cream, butter, cheese, and ice cream.

Services range from health professionals, to teachers, to mail carriers, to garbage collectors. Some service businesses sell products; fast food restaurants sell hamburgers and more. This makes classification more difficult. Many authorities divide service business into sales and services. How you choose to classify them is not of great concern.

TYPES OF BUSINESS ORGANIZATIONS

How Businesses Organize to Do What They Do

Businesses can be classified into five legal categories on the basis of their organizational structure: sole proprietorship, partnership, cooperative, S-corporation, and C-corporation. A brief description of each follows. More detailed information on each is provided in Chapter 21 on legal concerns.

SOLE PROPRIETORSHIP

A sole proprietorship is, as the name indicates, an organizational form with a single owner. This type of business organization is a very common start-up method. The commonly recognized characteristics of this type are the following:

1. It is the easiest way to start a business.
2. It is the simplest business organization.
3. Management decisions are easiest to make.
4. The owner has complete control of the enterprise.
5. The owner receives all the profit (or suffers all the losses).
6. The business may be full- or part-time.
7. It is the easiest form of business to end.
8. It has the simplest tax basis.
9. The total risk is controlled by the owner.

PARTNERSHIPS

Partnerships are businesses with ownership divided between two or more individuals. Partners may be active or silent, the active partners operate the business, while the silent partners provide investment of capital and may or may not participate in day-to-day decision making. The usually recognized characteristics of partnerships are the following:

1. There is divided control of the operation.
2. The capital is divided.
3. The profits (or losses) are divided.
4. Partners provide added knowledge and skills to the business.
5. There is a need for a partnership agreement.
6. Each shares responsibility for the other partner's actions.

COOPERATIVES

The cooperative form of business organization is designed to serve or benefit the members of a group. This may be either a producer's or consumer's group. The recognized characteristics of a cooperative are:

1. Trading is at market prices.
2. Ownership is by current participants through stock shares or revolving funds.
3. One member has one vote
4. Dividends are based on participation.

CORPORATIONS

The corporation may have few or many owners with ownership divided into stock shares with varying shares held by individuals. A special form of the corporate organization is known as an S-corporation. It differs from a C-corporation in that it has a limited number of owners and each owner pays taxes based on his or her share of the profit. C-corporations are taxed on their profits. Then, in addition, each stock owner is taxed on dividends as an individual. The generally recognized characteristics of a corporation are the following:

1. Stock share ownership.
2. It is the most difficult type to start.
3. Management decisions for change are most difficult.
4. Taxation is most complex.
5. Shareholders elect the management.
6. Start-up costs are highest.
7. It is subject to the most regulation.
8. Liability is limited to investment.
9. Profits are taxed twice in a regular C-corporation.

SELECTING A BUSINESS OPPORTUNITY

Finding a Business to Start

In this chapter we have looked at some characteristics of successful entrepreneurs and have encouraged you to examine your own potential interest in becoming an entrepreneur. Now it is time to look at some potential businesses to enter. How do you make a rational decision regarding which business to enter? You **research** the market. This research will help answer questions such as the following:

1. Will the population in your area support the business of your choice? For example, in 1985 there was one grocery store for approximately every 2,000 people in the U S, while there was only one luggage and leather goods store for every 122,000 people.
2. Who are your competitors?
3. How will you compete? On price? On quality? On service?
4. Can you identify a sustainable competitive advantage?
5. What licenses and permits will you need?
6. Will a new or innovative product or service appeal to potential customers?
7. Do you have the needed knowledge for the business of choice?
8. Do you have the needed skills?
9. Do you have, or can you obtain the needed capital?

Chapter 22 – *When Help Is Needed* – may prove useful as you start the research recommended above.

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FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Select 10 local businesses and identify their types of business organization.
2. Classify these 10 businesses as to service, sales, production, or combination businesses.
3. Draw up a partnership agreement for discussion, or obtain a sample copy to review. (A sample agreement is included in Appendix A.)

Activities to Aid Decision Making

1. Develop a list of potential businesses you could start based on your knowledge, skill, and capital.
2. Can you define your competitive advantage for each potential business you listed?
3. Rank the list based on your interest.
4. Identify three entrepreneurs who recently started a business and interview them. Ask questions such as the following:
   a. What motivated you to start a business?
   b. What were the biggest problems in starting?
   c. What are your biggest satisfactions?
   d. What is your competitive advantage?

Questions to Increase Your Understanding of the Text

1. Why should an employee have a current resume?
2. Why do pink slips contribute to business start-ups?
3. Which three advantages are most important to business start-ups?
4. What do you consider the most important advantage of a sole proprietorship? Why?
5. What is the most important advantage of a partnership? Why?
6. What is the most important advantage of the corporation? Why?

Questions to Aid Decision Making

1. Are job layoffs common in your community? In your company?
2. Have you saved some money for a safety net?
3. What business interests you?
4. Is there a business opportunity in your community? Describe it.
5. Is there a business opportunity in a nearby community?
6. Would you be willing to relocate to start your dream?
7. Do you have the knowledge needed in the business?
8. Do you have the skills needed in the business?
9. Do you have the capital, or can you obtain it?

PART II

Planning for Entrepreneurship

CHAPTER 3

The Idea of Goal Setting

CHAPTER GOALS

- To help you learn how to set and organize goals.
- To help you inventory your time usage.
- To encourage you to utilize available time productively.
- To help you avoid procrastination by using time management skills.

KEY CONCEPTS

Articulate – Able to speak effectively.

Attainable – Can be achieved.

Challenging – Requires special effort.

Consumption – To use up.

Criteria – Measure of value.

Doers – People who accomplish things.

Dreamers – People who have big ideas, but never do them.

Expectations – Anticipated results.

Goals – Things we strive to achieve.

Immediate goal – Something to achieve this year.

Long-term goal – Something to achieve in a lifetime.

Motivation – Something physical, financial, or emotional that causes us to act.

Procrastination – Putting off action.

Self-esteem – Self-confidence.

Short-term goal – Something to achieve in the next one to five years.

CASE STUDIES

Krys Covets a Corvette

Krys Szalasny graduated from high school and went to work for a nursery and landscape business. He started a savings account for the sports car he had always wanted. His employer, Fred, operated the business as an S-corporation. Fred was looking for capital to buy some vacant acres nearby; he planned to plant seedlings to broaden the scope of the business.

Krys' grandmother died and left him $30,000. His father urged him to invest the money in his boss' business by purchasing some shares of the company stock. Krys had other ideas. He had seen the shiny red Corvette on the local dealer's lot and quickly spent his savings on the car of his dreams.

Krys continued to work for the nursery and landscape business as he drove his new car proudly to work each day. He gave little thought as to how the car would be replaced when it wore out. Krys just didn't want to buy into a business when he could buy what he wanted right now.

Con Aims High

Con Raider graduated in the same class as Krys but his motivation was different. Con had wanted to be a mechanic and from the time he first flew in a small airplane, he knew he wanted to fly his own plane. Con lived two miles from a small airfield and he rode his bike to the field during every spare moment. He became friends with the mechanics and soon became an unpaid helper, running errands and doing small tasks for the mechanics.

During the summer months he quickly became a useful helper, and by his junior year he talked his way into an exchange of labor in the shop for flying instruction. In two years he completed his first solo flight and obtained his pilot license. He became a full-time mechanic and saved until he bought his first airplane.

Con now owns his own flying service. He does charter flights and also specializes in aerial photography.

Even as we choose between **consumption** now, versus investment now and more consumption later, the consequences of our decisions are often significant. Choosing more education, choosing to buy stock or start a savings account, or choosing to take a second job for a while can all be examples of choosing to invest one's resources rather than to consume them now. Often, the payoff is the opportunity for much greater future consumption.

Notes from the Case Studies

1. Both young men had **goals**.
2. Both young men worked for their goals.
3. Krys' goal was a new sports car.
4. Krys' goal was short-term and shortsighted.
5. Con's goal was to fly his own plane.
6. Con's goal was future-oriented and more farsighted.
7. Each of us are motivated by different goals.
8. Krys derived immediate satisfaction from his purchase.
9. Con's goal took longer for satisfaction.
10. Con built a growing business on something he liked doing.

SETTING GOALS

Where Am I in My Plan?

MOTIVATION

Motivation is something that causes us to act. It can be a physical need, emotion, or a desire. When we are hungry we want to eat. When it gets cold we put on a sweater or jacket. These are physical motivations. When we are lonesome we visit or call someone we like. This is an emotional motivation.

Psychologists have complex theories about motivations and their importance. We are not interested here in discussing those theories; we are aware that people are motivated by different things as they live out their lives. Our purpose is to get you to think about your motivation, or what "turns your crank" now.

Look at the following list of items and think about your **expectations**. This may help you understand what you want to accomplish by starting your own business.

1. Money
2. Material things
3. Recognition by others
4. Authority over others
5. Respect
6. Self-satisfaction

Entrepreneurs typically work to meet their own expectations of their businesses. As individuals we often perform as others expect us to perform. Entrepreneurs have a drive within that keeps them going. Lee Iaccoa calls it "a fire in your belly."

In Chapter 2 we listed the advantages of being your own boss. Review the list and clarify your motivations. Most entrepreneurs like the independence of being their own boss and making the decisions that affect their own lives.

The Importance of Goals

You probably know some people who always have "big" plans that just never seem to come about. Their plans never get beyond the planning stage. Last week's idea is replaced with a new one this week. They are **dreamers**, not **doers**. You also probably know some people who never say too much about their plans, but work quietly until their dream is a reality. These people are doers. Are you a dreamer or doer? Perhaps you do your dream!

Consider the following three questions about goal setting:

1. What motivates people to set goals and pursue them?
2. What is the difference between a dream and a realistic goal?
3. How does goal setting apply to you as you start your business?

Opportunity alone does not pave the way to success. The two case studies at the start of this chapter illustrate the importance of planning.

What Are Goals?

A simple definition of a goal is something we strive to achieve. Goals are ends toward which we direct our energies. They give us something to work for. If we have no goals our lives are fairly dull.

Goals are the destinations on our road map. If we want to go to Kalamazoo, we get out a road map and plan which highways to take to get there. We plan the trip by the most direct route to our destination. When we hit a detour we change the road we follow, but our objective – getting to Kalamazoo – remains the same.

Goal setting is very similar. You decide where you want to go in life and plan ways to get there. You can create a time line for the direction you want your life to take using **immediate**, **short-term** and **long-term goal-setting** habits. Then you begin to follow your "road map" from point to point. You may find some detours, but your goals or objectives can remain intact.

If goals are so important, why doesn't everyone set goals? First, goal setting is a skill. Many people don't have any instruction or practice in setting goals. They can't visualize what they want to achieve. Their big idea is vague and undefined. Therefore, the goal lacks the enthusiasm, commitment, or resources to bring it about. Second, most people have a large dose of human inertia. They go with the flow or do the easy thing as long as they are comfortable. A third reason is fear of failure or a lack of **self-esteem**.

Some people would like to do something, but just never quite **articulate** it as a goal. Others simply don't know or think about setting goals for themselves. Still others don't carry out their plans. But remember this story about a woman who had a lovely garden. Someone said it looked as if she had waved a magic wand over the ground and the flowers appeared. She replied, "I did, and it had a hoe on the end of it too."

DREAM SOME

1. **Ask yourself these questions:**
   What do you want to accomplish today; tomorrow; next week; next year; or 5, 10, 15, or more years from now?
2. **List your goals and dreams.**
   List everything you think of, realistic or not. At this stage you are dreaming and it's okay to reach for the stars. Remember, if you don't dream, your dreams have little chance of coming true! If you are reading this text, one of your goals is probably to start your own business.
3. **Organize your goals.**
   Group the goals by the length of time that you think it will take to reach them. Some will be daily or immediate goals, while others may require years to achieve.

4. **Evaluate the list.**
   Eliminate those things that are not important to you. Take a hard look at those goals that don't seem to be practical. Some of your goals may even have conflicts built in.

5. **Consider your family.**
   How will your business goals affect your family? What sacrifices will be needed? How will your business goals impact your family's life style during the early years? Consider the family living budget for the first year or longer as the business starts (perhaps you will reorder your goals).

6. **Reevaluate your goals on a regular basis.**
   It's O.K. to decide to go somewhere other than the original destination. However, make the decision – don't just drift along.

Each time you finish you will have a set of goals that meet criteria. They will be realistic; they will be **challenging** and **attainable**.

You Can Get There from Here!

One place to begin reaching your goals is to manage your time. The time available for developing the business plan can be identified by using Figure 3-1 to record your current time usage. In activity 1 at the end of this chapter you are asked to use this chart for a week and summarize the totals devoted to different activities.

Understanding how you use the 24 hours you have in a day and the 168 hours available in every week is the beginning of this first step. Some people do much more in the same period of time. Even if you or I watch television for only 2 hours per day, that adds up to 14 hours per week or 730 hours per year! That's the equivalent of more than 18 forty-hour work weeks!

Procrastination

Are you a procrastinator like me? Try to fight the **procrastination** syndrome most of the time. How can you tell if you are a procrastinator? Look at these items and answer for yourself? *DO I:*

1. Put things off until the last moment?
2. Say I work better under pressure?
3. Avoid doing new tasks?
4. Hate starting a big job?
5. Say I don't have enough time right now?
6. Do the easy and avoid the difficult jobs?
7. Avoid things I might risk failure by doing?
8. Trap myself by overindulging in socializing, recreational reading, movies, TV, and similar activities?

If you answer many of these questions with a "yes," you need to beware of the "procrastination bug." Remind yourself of the pilot's axiom, "You can't use the runway that is behind you." You can't recover the time that is past. All you can do is benefit from its lessons.

How I Used My Time Today

Activities	Sleep	Meals	Travel	Work	Hobbies	TV	Family	Study	Reading		
12-1 am											
1-2 am											
2-3 am											
3-4 am											
4-5 am											
5-6 am											
6-7 am											
7-8 am											
8-9 am											
9-10 am											
10-11 am											
11-12 am											
12-1 p.m.											
1-2 p.m.											
2-3 p.m.											
3-4 p.m.											
4-5 p.m.											
5-6 p.m.											
6-7 p.m.											
7-8 p.m.											
8-9 p.m.											
9-10 p.m.											
10-11 p.m.											
11-12 p.m.											

Put check marks in the columns to indicate what you are doing during each hour of the day for each day of the week. Use a blue pen for weekdays and red for the weekend.

Figure 3-1 My time-use inventory

Now that you recognize some of the procrastination time thieves, how do you defeat them? Declare war on procrastination! Following are some points for your attack:

1. Admit you waste time.
2. Cut off your escape routes.
3. Set priorities and concentrate on one thing at a time.
4. Set deadlines for yourself.
5. Have someone check on your progress at reasonable time intervals.
6. Break big jobs into smaller units and get started.
7. Don't avoid the unpleasant.
8. Just do it!
9. Handle paper once: answer it, file it, or pitch it.
10. Procrastinate positively by sitting in a chair and doing absolutely nothing. Don't read, shuffle papers, knit, or watch T.V. Just sit. Do this for 15 minutes and don't cheat. Getting started will become a great alternative!
11. Make a "to do" list and use it.
12. Cross off the items as they are completed.

ADDITIONAL READINGS

1. Abrams, R. M. *The Successful Business Plan: Secrets & Strategies.* Oasis Press, 1991. pp. 29-38.
2. Ashmore, M. C. *Risks and Rewards of Entrepreneurship.* St. Paul: EMC Publishing, 1988. pp. 94-99.
3. Green, D. H. *Consumers in the Economy.* South-Western, 1992. pp. 72-87.
4. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 27-39.
5. Kamoroff, B. *Small Time Operator.* Bell Springs Publishing, 1991. pp. 14-25.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Complete the chart in Figure 3-1 for the next week.
2. Summarize the chart for each activity.
3. Identify the leisure time you could use to develop a business plan.

Activities to Aid Decision Making

1. Plan a new schedule to free up time to develop your enterprise.
2. Write 10 immediate and long-term business goals for your enterprise.
3. Interview an entrepreneur with a home-based business and find out how he or she budgets the time.
4. Use a 3-by-5-inch note card each day to write your 10 immediate goals for the day; carry over items not completed and cross off the items finished.

Questions to Increase Your Understanding of the Text

1. What is a goal?
2. How often should we set goals?
3. What are the characteristics of a good goal?
4. What are priorities?
5. How do we determine priorities?
6. What is motivation?
7. Name four reasons people fail to set goals.
8. What is the difference between dreaming and realistic goal-setting?

Questions to Aid Decision Making

1. What changes in activities can I make to develop my business?
2. How can I benefit from researching and writing my plan?
3. What has my experience with the note cards told me about my goals?
4. How will I apply goal-setting concepts to my business?
5. How do I rank the motivating forces from most to least important? Does this ranking tell me something about my business activity?

CHAPTER 4

Considering the Alternatives

CHAPTER GOALS

- To identify reasons for purchasing a business.
- To identify the advantages of starting from scratch.
- To identify the disadvantages of starting from scratch.
- To identify the advantages and disadvantages of a franchised business.
- To identify the ways most enterprises get started.
- To help you evaluate a business you might purchase.

KEY CONCEPTS

Break of the scale – The amounts between five-pound intervals.

Complemented – Added to, or completed a whole.

Consignment – Supplied with the payment to be made when sold.

Franchise – A business that pays a fee for using the parent company's logos, supplies, and management help.

From scratch – A start from nothing.

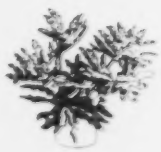
Horticulture – Study of the science of growing fruits, flowers, or shrubs.

Logo – A distinctive company symbol or trademark.

Market niche – A well-defined segment of a market.

CASE STUDY

Junita Starts on a Shoestring



Junita had worked for a local greenhouse operator who was unable to compete profitably with other larger operations in the area. Junita had completed four years of high school **horticulture** in her local school. She was confident she knew what mistakes her boss was making, but was unable to be convincing because of her age and lack of experience.

She discussed her options with a former teacher and her grandfather, who had sold his hardware store and retired. Both had confidence in her ability and desire to succeed. Each could provide excellent advice: the teacher on horticultural items and her grandfather on business management. Her decision was to start with a small business and grow with the loyalty she could earn from her customers.

Junita was single and lived with her parents. She had a small savings account and few personal expenses. Their home was beside her grandfather's six acres in a small community near a large urban area. The climate was appropriate for nearly year-round plant growth, so a minimum of heating would be required in the plastic greenhouse built on her grandfather's acreage.

Her younger brother and grandfather supplied labor when needed and her seven-year-old station wagon provided transportation. Junita developed her marketing plan around Bess, an acquaintance who operated a successful craft shop. Bess provided her with a 10-by-20 foot space at the front and side of the store at a cost share rent. Both businesses **complemented** each other to mutual advantage.

Since Junita's shop was eight miles from her former boss' greenhouse, a **consignment** arrangement was made. Junita had a great support team, and after three years of developing her business, Junita needed more space. She discussed this problem with Bess, who offered to sell the store. After careful planning and budgeting, Junita borrowed the money from her grandfather; thus was born Junita's Boutique.

Notes from the Case Study

1. A support team is always important to the beginning entrepreneur.
2. People are willing to help young people interested in their field.
3. Many people find it best to start their businesses **from scratch**.
4. Family labor often helps a beginning entrepreneur.
5. Family funds often provide start-up capital.
6. Suppliers can sometimes be found who will provide merchandise on a consignment basis.
7. Customer loyalty is valuable to a new business.
8. Junita waited until the business was growing before borrowing money from her grandfather.
9. Junita learned the craft business by working with Bess.
10. The two businesswomen helped each other, each tending store when the other needed to be away from the store.

MAKING THE BUY-OR-BUILD DECISION

Advantages of an Established Business

Most authorities recognize the advantages of purchasing an established business. Among those commonly listed are the following:

1. The business has customers.
2. The business has name recognition.
3. Suppliers know the business.
4. Local ordinances have been satisfied.

5. The previous owners can tell you about the necessary licenses and permits.
6. Inventory and cash flow projections are easier to make.
7. Past records can help in decision making.
8. Employees can provide information.
9. Employees are already experienced.
10. Business equipment is already in use.
11. The location and facilities are set.
12. Buying a business eliminates one competitor.

The qualities of name recognition, active cash flow, and suppliers in place are big advantages to the beginning entrepreneur. Information regarding legal aspects and the specific business from the previous owners and employees are additional powerful advantages in the purchase of an established business.

Disadvantages of the Purchase of an Established Business

The purchase of an established business ties you to any existing problems. For example, if the business has a poor public image it will take time and effort to reverse the public's perception. If the business has not remained competitive in costs of labor, qualified employees will be difficult to attract and retain. If the wage scale is too high, the competitive advantage will be hard to maintain.

Policies that have been locked in may be difficult to change, and employees accustomed to a given method of operation may resist changes. The commonly listed disadvantages of the purchase of an established business are as follows:

1. Wage scales are in place.
2. There are existing company policies.
3. The existing employee attitudes and habits may present problems.
4. The existing public image may be hard to change.
5. The existing equipment may be obsolete.
6. The existing location may not be the best.
7. The existing inventories may be unsuitable.

Advantages of Starting from Scratch

When you start a totally new business you avoid all the disadvantages of an established business, but you also forfeit the advantages listed for purchasing an established business. To many people, the advantages outweigh the disadvantages. One of the major advantages of a clean start is the opportunity to put your personal stamp on the business from the start. For example, when Bill entered the grain business he had heard many complaints about "funny weights." Therefore, one of his first actions was to have customers make the weights and stamp the tickets, and to give the customer the **break of the scale**. No more complaints were made about the weights from his elevator.

Total creativity within the confines of the law, rules, and regulations is also possible with a fresh start. Commonly accepted advantages of totally new businesses include the following items:

1. You can use your creativity.
2. You select the appropriate location.
3. You select the equipment and arrange the facilities.
4. You hire employees and train them to your philosophy.
5. You create the business image.
6. You select suppliers, thus determining quality.
7. You determine the **market niche**.
8. You have no bad history to live down.
9. You have no policies to change.
10. You have no established wages or benefits to consider.

Disadvantages of Starting from Scratch

Entrepreneurs must face the realities of starting a business from "ground zero." Many people list the following disadvantages of starting a totally new business:

1. Financial risk of personal assets pledged to secure the business loan.
2. Sacrifices are expected from family members.
3. Cash drought at the beginning until sales bring in money.
4. Stress caused by need to meet payroll and other commitments.
5. Problems not anticipated may delay cash flow.
6. Marital problems stemming from time commitments.
7. Marital problems caused by financial hardships.
8. Mental or physical problems due to stress.
9. Loss of faith in the enterprise due to cash problems.

Considering a Franchise

• FRANCHISE •

Franchises offer several advantages for an entrepreneur with the necessary capital. A franchised business is one that has paid a fee for the rights to use a company's name, **logo**, and supplies. It benefits from the parent company's buying power, quality control, advertising, supervision, and management aids.

The ten largest franchising companies range from *PepsiCo* with 17,532 units to *Service Master* with 4,000. The average total investment in a franchise is $147,570, ranging from as little as $1,500 to as much as $610,000. The average annual income before taxes is $124,290 (reported by franchise owners). Only 18 percent of the reporting franchise owners are women (reported by *USA Today*).

Many fast-food outlets are recognizable franchises. Commonly recognized advantages of the franchise business are the following:

1. Name recognition
2. National advertising
3. Uniform quality control
4. Management support
5. Supplies from one source

Many people have created successful careers for themselves by buying and "renting out" a franchise. Some franchise owners manage several outlets.

Disadvantages of a Franchised Business

The major disadvantages of the franchise are cost and control. In obtaining a franchise the entrepreneur must be able to put a considerable capital investment up front. In addition, the entrepreneur is most often required to provide a look-alike building and agree to other conditions of operation. The parent company wants uniformity in its franchises and products.

Other franchise requirements must be weighed against the advantages when deciding on a franchise. Many local entrepreneurs have successfully started essentially look-alike business with many features similar to a franchise, but without the many franchise benefits or disadvantages.

Questions to Consider before You Buy

The purchase of a business is a major undertaking and should be carefully thought out and researched before the purchase is made. We suggest you obtain answers to the following questions before you invest:

1. Why is the business for sale?
2. Will the owner partially finance the purchase, or rent the facilities with an option to buy?
3. Is the business seasonal?
4. Is the business well managed?
5. How many of the deficiencies noted in the operation of the business can you correct?
6. Can you obtain the needed finances?
7. Is the location advantageous?
8. Will the clientele accept new ownership?
9. Do you have, or can you get the needed skills for that business?
10. Have you and your accountant looked at the last three years' records and tax returns?
11. Did the business grant credit to customers? If so, can you continue?
12. Is the business profitable?
13. How can you improve the profit potential?

Surveying the Local Scene

If you plan to go into business in your home community, you need to look at it from a fresh viewpoint – one related to the business you plan to enter. What is the competition for your business? What are their strengths? Their weaknesses? How can you improve the product or service? How can you obtain the customers needed?

In the case of a planned purchase of an established business, how well do you really know the business? Investigate the business opportunity just as you would a business two or more counties away.

ADDITIONAL READINGS

1. Abrams, R. M. *The Successful Business Plan: Secrets & Strategies.* Oasis Press, 1991. pp. 11-19.
2. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 41-57.
3. Kamoroff, B. *Small-Time Operator.* Bell Springs Publishing, 1991. pp. 23-31.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Visit with a real estate broker who specializes in selling businesses. Discuss what questions are asked and what questions should be asked.
2. Read the "businesses for sale" section of the newspapers for several weeks and note the business opportunities listed.

Activities to Aid Decision Making

1. Discuss with the realtor the business opportunities of interest to you.
2. Discuss the terms for the purchase of one or more of the business opportunities.

Questions to Increase Your Understanding of the Text

1. How important is a supportive family?
2. What is a consignment sale?
3. List six advantages in purchasing an existing business.
4. Which are the most important advantages to you? Why?

5. Which three disadvantages do you consider most important? Why?
6. Which four advantages of starting from scratch seem most important? Why?
7. Why are franchises popular?
8. Are there other questions one should ask before buying a business?

Questions to Aid Decision Making

1. How many businesses are for sale in the area of interest?
2. How many businesses will compete directly? Indirectly?

CHAPTER 5

Reviewing the Start-up Plans of Others

CHAPTER GOALS

- To identify the contents of a business plan.
- To identify strengths and weakness of a specific plan.

KEY CONCEPTS

Anchor store – Major department store.

Balance sheet – A financial report summarizing a business' financial condition categorized by assets, liabilities, and the owner's equity at a given point in time.

Budget – Careful analysis of anticipated income and expenses.

Business plan – A detailed written plan for the operation of a business enterprise.

Capital equipment list – Record of depreciable equipment.

Demographics – Detailed information about the people in the area.

Equity – Degree of ownership.

Fixed costs – Costs that do not vary with volume of sales or production.

Foot traffic – Number of people who pass by the location.

Marketing plan – A plan for promoting your product or services.

Owner's equity – Value of the owner's share of the business.

Private funds – Finances obtained from noncommercial sources.

Risk – A chance for profit or loss.

Risk taker – One who takes risks, an entrepreneur.

SCORE – Service Corp of Retired Executives dedicated to providing advice to aspiring entrepreneurs.

Value added – Changing a product into another of higher value – e.g., milk into ice cream.

Variable costs – Costs that vary with production or sales.

Venture capitalist – Investor who makes a business of funding new businesses.

CASE STUDY

Score One for SCORE!

While she and her husband were in college, Georgette baked large cookies and sold them to help pay expenses. Now that her husband has a good engineering position, Georgette decided she would become a risk taker and start a cookie business. With her husband's support she restarted the activity that helped finance their last year in college.

Georgette did her homework and went to the local **SCORE** chapter to seek their management advice. Georgette knew that SCORE is an organization of retired business executives who are dedicated to helping entrepreneurs with free consulting advice.

As one of the members likes to tell it, "We didn't snicker, but didn't provide too much encouragement." Georgette had located two mall location vacancies with adequate floor space. She completed a tentative cash flow budget to share with SCORE based on **fixed** and **variable costs**. She researched the **demographics** including the amount of **foot traffic** at various times of day. One space was in a strip mall without an **anchor store** and the other, higher priced one, was in a mall that had a major national retail store.

Georgette made her decision after consulting with her SCORE advisory team and reviewing the comparative data. She chose the higher priced location reflecting higher foot traffic. Then Georgette went to see the mall managers. The managers were cautious because turnovers, failures, and vacancies are disliked by the investors in the mall. Her good **business plan** helped in leasing the space. Georgette began baking and selling her "Monster Cookies."

Warm cookies were a hit with the customers in that mall, especially the five-to-nine-year-old children shopping with parents or grandparents. Today Georgette has an outlet in malls in seven cities. Her business plan worked! And she is still working her plan!

Notes from the Case Study

1. SCORE is a national network of men and women who are available for advising budding entrepreneurs.
2. Careful study pays off when selecting a business location.
3. Most successful malls have a major national retail store.
4. Her SCORE advisors pointed out the fallacies in Georgette's plan.
5. The advice helped Georgette fine-tune her plan.
6. Mall managers review the business plans of potential tenants to reduce turnover rates.
7. One's spouse is a powerful support when starting a business.
8. Georgette worked her plan, and her plan worked!

THE BUSINESS PLAN

You start where you are, with what you have, to get what you want. Start with your physical and financial balance sheet, the recipes or ways you are now using your resources, other recipes you might use, and your goals. In a business plan you propose to start where you are and project what you are going to do.

In real life, you start every day where you are, with what you have and you decide what to do that day. Each day, based on any new information you gather, you can/should update your business plan, and then do what you think best. Some days you may make no changes because you have no new information to use in trying new recipes. We all do this. It's just that we do it informally.

A good business plan is a road map to use daily. Researching and writing the plan helps you think through the multitude of details an entrepreneur needs to consider in starting and carrying out a business. The biggest value of the business plan is to you as you search for the best combination of recipes and ingredients.

You start your plan with ideas and your inventory of resources: physical, financial, and mental. Your balance sheet of physical and financial resources is an important element of the inventory. Also, your personal and business goals are part of this inventory. Your location, your current business or job, and a spouse's business or job are also included. It is an information database you draw on to develop a business plan.

In your plans, you outline your expected future performance. Your records confirm your past performance. When you want to communicate with others in order to obtain additional financial backing, you will likely write a business plan. Such a business plan usually contains two main sections: the business description items and the financial plans.

Business Description Items

1. Your resources
2. Your goals
3. Your location
4. Your product or service
5. Your competition
6. Your market and how you will penetrate it
7. What regulations will affect the business
8. Your marketing plan
9. Your employees
10. Your management organization

Financial Items

1. Balance sheet
2. Income projections
3. Cash flow projection
4. **Capital equipment list**
5. Sources of funding
6. Application of funds
7. Past financial reports

These **BUSINESS DESCRIPTION ITEMS** and **FINANCIAL ITEMS** are discussed in detail in the following text.

RESOURCES

Describe the resources you have. This section of the plan spells out the space, equipment, personnel, and supplies you have or will need to operate the business. Check with potential suppliers to find out if they can supply your needs in a timely fashion. Can you rent or lease the equipment needed until the business is firmly established? We have just provided suggestions for a young man as he and two partners set up a clinic where the needed equipment is on a lease purchase plan. If the business succeeds, the end of the lease becomes a purchase. This arrangement permits the business to use limited capital for current operational expenses during the critical start-up phase of the business.

GOALS

Your goals section should answer questions such as the following:

1. What are your plans for the business?
2. Will you subsidize it with your mind, muscle, or money resources?
3. When will you need to draw funds out of the business?
4. How much time and energy can you commit to it and for how long?
5. Do you want surplus funds to expand the business or do you expect to withdraw surplus funds?

LOCATION

Where will you operate your business? Will the location permit the business to grow? Will the location provide the services needed such as water, sewer, access roads, parking, electricity, and trash disposal?

PRODUCT OR SERVICE

More specifically describe the product or service you are now providing or thinking about providing. Describe any special features that will encourage purchase or use. As you prepare this section ask yourself some of the following questions:

1. How can I convince people to use my product or service?
2. Will people want the product or service?
3. Are people buying the product or service now?
4. Is it a necessity or a luxury to my target audience?
5. How does the economic outlook affect the product or service?
6. Will people continue to want or need the product or service?
7. When will new technology make the product or service obsolete?

COMPETITION

What is the nature of competition in your chosen area? What will be your sustainable competitive advantage? Will you compete on price, uniqueness, quality, or service?

MARKET

Who are the customers you want to target? What are their incomes, interests, and needs? Obtaining demographic information about the targeted groups strengthens your plan.

LAWS AND REGULATIONS

What are the licenses, permits, and regulations the business will be subject to? The services of an attorney experienced with start-up businesses are probably needed at this time. This attorney has knowledge and expertise you need. The fees are probably one of your wisest expenditures when starting a business.

MARKETING PLAN

Georgette made great cookies, but her success was not guaranteed with just that fact. Unless people learned that Georgette made great cookies her sales would not have paid the rent! How did Georgette let people know about her great cookies? She advertised. The word-of-mouth advertising from people who liked Georgette's cookies was great, but it was too slow. She used other methods.

Put your creativity to work and get out the message. In this section detail your advertising and promotional plans. Also consider the image you wish to project. Image includes the atmosphere in your shop, or the age and appearance of your delivery trucks. In your plan include whether you will emphasize quality or price.

EMPLOYEES

Will your enterprise need employees in the beginning? If so, what criteria will be used to select them? How will they be paid? What will be their benefits and other important specifics?

MANAGEMENT ORGANIZATION

Will your enterprise be a sole proprietorship, partnership, S-corporation, or C-corporation?

FINANCIAL PLAN

This is a very important part of your plan. The largest cause of business failures is consistently reported as under-funding (the business runs out of cash). Locally a company was formed to provide a **value added** service for an agricultural product. The company ran out of money and was foreclosed just as they developed the market and solved the production problems. Their problems persisted over a sufficient time period that they were unable to obtain the additional funds to carry on. Cash flow was inadequate in the short run. Longer term financing would have given them a much better chance to succeed.

Your plan must include a balance sheet that details your assets and liabilities. (A sample balance sheet is shown in Figure 5-1 on page 53.)

An income statement or cash flow forecast projected by the month for the first and second year will detail your expected income and expenses for the start-up years. To establish this projected cash flow forecast, start with the cash on hand at the start of the business. Estimate monthly revenues and expenditures and show the ending balance at the end of the month. Negative amounts show the extra cash needed for that month. The ending balance becomes the cash on hand for the start of the next month, etc. (Cash flow forecasts appear later in this chapter.)

Securing Backing for Your Plan

Unless you have very deep pockets you will probably need to promote your plan to others in order to obtain the needed financing. Where do you look for financial help? *USA Today* reports that 90 percent of short-term debt and 70 percent of long-term debt is held by banks.

However, most banks won't loan much money to start-up businesses with little equity or evidence of past performance. Funding is difficult for the beginner to obtain unless a person has a strong equity position and a very convincing business plan. Most beginning entrepreneurs obtain **private funds** for their start-ups.

Besides banks, some entrepreneurs find debt financing from **venture capitalists** and commercial loan companies. The best sources of funds for most would-be entrepreneurs are friends and relatives.

A word of caution about borrowing from family and friends or other relatives: when you borrow such funds they may expect to participate in the business decision making which may cause ill feelings or resentment.

Equity financing is an alternative to debt financing. Entrepreneurs get **equity** capital by sharing ownership with others. Recognize the potential problems associated with sharing ownership of a small business. You may be management, labor, and part owner. Others may be only part owners. At the beginning, decide how you will divide earnings among management, labor, and ownership.

Also recognize that venture capitalists who consider investing in your business may insist on providing management or other expertise. Since venture capitalists may read fifty or more business plans a week, they may call in other experts to also review your plans. They will recognize your good ideas, point out your weak ideas, and probably insist on changing some of your plans.

If a venture capitalist is interested in your business, you will have a choice. Do you want this person's help, but also his/her demands? This decision can be quite significant. It is possible that others can help you become more successful than you can be alone. You might even be faced with the prospect of owning 49 percent of a potentially large business (and thus lose control of your enterprise) versus owning 100 percent of a potentially unsuccessful business that you control.

Reviewing Beth's Corner Bakery Business Plan

(This is an active business plan developed to encourage funding. The plan is used with the permission of its writers.)

RESOURCES

Mind Resources

1. Four years of experience in this business as an employee
2. Knowledge of the customers and their purchasing habits
3. Husband's knowledge
4. Help of local resource people

Muscle Resources

1. Own time
2. Available family labor – teenage and college-age children
3. Provision of computer record keeping, payroll, and tax preparation services by husband
4. One exceptional employee

Money Resources

1. Personal savings
2. Second mortgage on residence

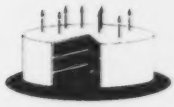
GOALS

1. Expression of personal creativity
2. Expression of health food style
3. Provision of employment for self, spouse, and children

LOCATION

The Corner Bakery will continue to operate at its present location on the corner of Walnut and Grove streets in Anytown, USA. The property consists of a 2,400-square-foot building with 16 parking spaces. The lunch room and display area is 30 by 40 feet and the building contains two restrooms, a kitchen, a storeroom, and a small office.

The facility is currently being operated as a lunch room and deli with a limited catering service.



PRODUCTS AND SERVICES

The products and services to be offered are the following:

1. Specialty cakes
2. Baked goods
3. Deli items for carryout
4. Enlarged catering service for events serving up to 400 people
5. Breakfast menu
6. Soup and salad lunches

COMPETITION

1. *Bakery products* – a nearby donut shop and three grocery stores that sell packaged cakes and other items.
2. *Catering service* – A major catering service is located six miles from the Corner Bakery. It has banquet facilities the Corner Bakery cannot match. A nearby university offers opportunities for successful competition.
3. *Food service* – Six fast-food chain outlets are in the area. The Corner Bakery will not compete in the burger wars; instead the Corner Bakery will offer healthy soup-and-salad-type lunches and a tasty spice cake instead of donuts for breakfast and coffee breaks.

MARKETING PLAN

1. Expand the catering service.
2. Market specialty cakes for weddings, birthdays, and holidays by special order.
3. Market fresh-baked goods the same day as baked and reduce the prices before closing.
4. Add a breakfast menu.
5. Contact the university departments to promote catering services.
6. Continue to serve the customer base already in place.
7. Advertise in the local paper.

EMPLOYEES

Retain current employees and add one to take over the new owner's current responsibilities.

ORGANIZATION

The Corner Bakery will operate as a sole proprietorship.

FINANCIAL BUDGETS

The balance sheet at Beth's purchase is shown in Figure 5-1.

Note that the balance sheet is for the Corner Bakery entity and shows the assets and liabilities of the business. The assets of Beth Muehlhausen, the individual entity, will show the net worth of the Corner Bakery business entity since Beth owns the Corner Bakery.

Beth's Corner Bakery Balance Sheet as of 7/1/92

ASSETS	
Checking account balance	$ 4,765.21
Corner Bakery	60,000.00
Equipment	6,500.00
Food inventory	755.00
Utility deposits	1,300.00
Total assets	**$ 73,320.21**
LIABILITIES	
Loans	$ 25,000.00
Owner's equity or net worth	**48,320.21**
Total liabilities and net worth	**$ 73,320.21**

Figure 5-1 Corner Bakery balance sheet as of 7/1/92

The cash flow projections are based on the records provided by Stacey (the previous owner). The percentage of sales in each month of the year were computed and used in the projections. Figure 5-2 projects level sales. Figures 5-3 and 5-4 illustrate a 20 percent decrease in sales and a 20 percent increase in sales, respectively.

Discussion of the Plan

This plan was written for the purchase of an established business. Some of you are more likely to start a new business rather than purchase one. This plan will be useful in either case as you plan for a start.

The location of an existing business may or may not be an advantage. In this case the long-term lease was accepted by the landlord. The location and facilities are very familiar to Beth since she has worked in the business for four years.

Beth plans to expand the business because she thinks she can generate increased profit. She also needs more income to repay the higher investment. The breakfast menu is the first step in this direction.

In her plan, Beth recognizes the competition in each of the areas of business activities. This new owner has defined her competitive advantage and market niches very well.

A short series of statements define her business goals and will help her focus on their accomplishment.

The marketing plan does not spell out an advertising budget or plan for generating the required new business. It focuses instead on the quality and freshness that will be one of Beth's competitive advantages. No mention of market research is made. This section constitutes one of the weaknesses of the plan.

Corner Bakery Cash Flow Forecast – 7/1/92 - 6/30/93

Items	July	August	September	October	November	December	Jan. - June	Totals
Beginning balance	$ 4,765	$ 3,698	$ 5,685	$ 8,250	$ 9,278	$ 10,677	$ 14,778	
Sales receipts	11,905	15,978	16,761	14,705	15,194	18,797	93,340	
Available cash	16,670	19,676	22,446	22,955	24,472	29,474	108,118	
Wages	7,500	7,500	7,500	7,500	7,500	7,500	45,000	
FICA tax	589	589	589	589	589	589	3,534	
Rent	755	755	755	755	755	755	4,530	
Supplies	3,041	4,060	4,265	3,746	3,864	4,765	23,741	
Services	192	192	192	192	192	192	1,152	
Utilities	395	395	395	395	395	395	2,370	
Loan payment	500	500	500	500	500	500	3,000	
Total disbursements	**12,972**	**13,991**	**14,196**	**13,677**	**13,795**	**14,696**	**83,327**	
Ending balance	**$ 3,698**	**$ 5,685**	**$ 8,250**	**$ 9,278**	**$ 10,677**	**$ 14,778**	**$ 24,791**	

Notes: Allowances for insurance and legal fees were set at $2,000. Initial deposits and inventory were set at $ 2,055. Sales were projected for each month on the basis of sales recorded in those months the previous years. Supplies were projected according to the projected sales. Note that no sales taxes were accounted for in these estimates.

Figure 5-2 Beth's estimated cash flow for the Corner Bakery – 7/1/92 to 6/30/93

Twenty Percent Decrease in Sales – Corner Bakery Cash Flow Forecast 7/1/92 - 6/30/95

Items	July	August	September	October	November	December	Jan.-June	Totals
Beginning balance	$ 4,765	$ 1,925	$ 1,528	$ 594	$ 705	$ (162)	$ 1,133	
Sales receipts	9,524	12,782	13,409	13,039	12,155	15,038	76,672	
Available cash	14,289	14,707	14,937	13,633	12,860	14,876	77,805	
Wages	7,500	7,500	7,500	7,500	7,500	7,500	45,000	
FICA tax	589	589	589	589	589	589	3,534	
Rent	755	755	755	755	755	755	4,530	
Supplies	2,433	3,248	4,412	2,997	3,091	3,812	19,993	
Services	192	192	192	192	192	192	1,152	
Utilities	395	395	395	395	395	395	2,370	
Loan payment	500	500	500	500	500	500	3,000	
Total disbursements	**12,364**	**13,179**	**14,343**	**12,928**	**13,022**	**13,743**	**79,579**	
Ending balance	**$ 1,925**	**$ 1,528**	**$ 594**	**$ 705**	**$ (162)**	**$ 1,133**	**$ (1,774)**	

Notes: Allowances for insurance and legal fees were set at $2,000. Initial deposits and inventory were set at $2,055. Sales were projected for each month on the basis of sales recorded in those months the previous years by projecting a 20 percent decrease in sales. Supplies were projected according to the projected sales. Note that no sales taxes were accounted for in these estimates.

Figure 5-3 Beth's estimated cash flow for the Corner Bakery with a 20 percent decrease in sales – 7/1/92 - 6/30-93

Twenty Percent Increase in Sales – Corner Bakery Cash Flow Forecast 7/1/92 - 6/30/93

Items	July	August	September	October	November	December	Jan.-June	Totals
Beginning balance	$ 4,765	5,471	9,842	14,906	18,126	21,791	28,698	
Sales receipts	14,286	19,174	20,113	17,646	18,233	22,556	112,008	
Available cash	19,051	24,645	29,955	32,552	36,359	44,347	140,706	
Wages	7,500	7,500	7,500	7,500	7,500	7,500	45,000	
FICA tax	589	589	589	589	589	589	3,534	
Rent	755	755	755	755	755	755	4,530	
Supplies	3,649	4,872	5,118	4,495	4,637	5,718	28,489	
Services	192	192	192	192	192	192	1,152	
Utilities	395	395	395	395	395	395	2,370	
Loan payment	500	500	500	500	500	500	3,000	
Total disbursements	**13,580**	**14,803**	**15,049**	**14,426**	**14,568**	**15,649**	**88,075**	
Ending balance	**5,471**	**9,842**	**14,906**	**18,126**	**21,791**	**28,698**	**52,631**	

Notes: Allowances for insurance and legal fees were set at $2,000. Initial deposits and inventory were set at $2,055. Sales were projected for each month on the basis of sales recorded in those months the previous years with an increase of 20 percent. Supplies were projected according to the projected sales. Note that no sales taxes were accounted for in these estimates.

Figure 5-4 Beth's estimated cash flow for the Corner Bakery with a 20 percent increase in sales – 7/1/92 - 6/30-93

No mention of regulations or licenses are made because this is a continuing business and the necessary permits were in place. You will need to address these items in your planning.

The current part-time employees are all retained in the new business. One new employee will be added to replace the responsibilities of the new owner as she takes over the management duties.

The balance sheet shows the Corner Bakery with a strong owner's equity or net worth as Beth takes over. Cash flow forecasts complete the financial section. These illustrate a strength of the plan because they show the ability to survive nearly a 20 percent decrease in sales. Increased financial success from a 20 percent increase in sales is also shown.

No capital equipment list was presented. The equipment needed is already in use in the business. Give special attention to this part of your business plan because it helps you identify your needs.

The source of funding is shown as personal savings and the use of the home as collateral for a loan. Since the new owner is just starting, no previous financial reports are given, although the past Corner Bakery records could have been provided as shown elsewhere in this book.

Summary

Write your business plan to consider and clarify the many details involved in the start-up of a new business. Include enough detail to inform other people who are not knowledgeable in the field. Make the goals realistic, challenging, and attainable. Be honest with yourself, list any potential problems and how to solve them. Once you are in business, revise and update your plan. Do this often, including whenever you experience a major change. Also remember your plan will change many times as you implement it. A wise general once said, "No battle plan survives the first contact."

ADDITIONAL READINGS

1. Abrams, R. *The Successful Business Plan: Secrets & Strategies.* The Oasis Press, 1991. pp. 41-54.
2. Anders, R. L. and Dunkleberg, J. S. *Managing Small Business.* West, 1993. pp. 107-131.
3. Fry, F. L. *Entrepreneurship – a Planning Approach.* West, 1993. pp. 86-90.
4. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 15-25.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Do a library search to identify published business plans for study.
2. Interview a recent business start-up owner and inquire about his/her business plan and how it has worked.
3. Write improvements for Beth's business plan.

Activities to Aid Decision Making

1. Write your own business plan.
2. Visit your nearest SCORE chapter and have a management team critique your plan.

Questions to Increase Your Understanding of the Text

1. What are the purposes of a business plan?
2. What sections should a business plan contain?
3. What are the strengths of the Corner Bakery's business plan?
4. What are the weaknesses of the Corner Bakery's business plan?

Questions to Aid Decision Making

1. What are the strengths of your business plan?
2. What are the weakness in your business plan?
3. How can you strengthen these items?

CHAPTER 6

Solving the Location Puzzle

CHAPTER GOALS

- To identify location advantages.
- To identify location disadvantages.

KEY CONCEPTS

Accessible – Can be entered and exited readily.

Anchor store – A major retailer, usually located at the end of a shopping mall.

Bottom line – Profit.

Destination trips – Shopping trips to a particular store such as for groceries.

Proprietor – Manager or operator.

Related businesses – Businesses in the same field such as car dealerships and auto parts stores.

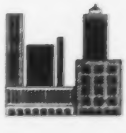
Traffic counts – Counts of vehicles passing a given point.

Visibility – Easily seen or prominent.

Zoning laws - Laws regulating location of certain types of businesses.

CASE STUDIES

Miller Misses the Traffic



Carl Miller decided to move his retail store from a small rural community of 550 population to the main shopping city of the area. With much fanfare he reopened three blocks from Main Street and one block from the secondary road leading to Main Street.

He had anticipated that his former customers would give him loyalty, while the larger city would provide increased numbers of customers. Because of the available location chosen, many of his former customers would not detour to patronize his store.

Carl's location was three blocks from the river that divided the city and there was no bridge on that street. This limited traffic by his store. Too late he realized his doubled rent was a real threat to profitability in the new location. After two lean years, Carl did some **traffic counts** and

additional research he hadn't considered earlier. Soon he was able to lease a building in a better location. Although the move was expensive and the rent was higher, it still improved his **bottom line**. However, more thorough research in the beginning could have saved Carl two years of frustration.

Pop's Goes with the Flow

Pop's was located near the downtown business center where there was inadequate off-street parking. The store was popular because of its mix of merchandise and the personality of Pop. He was always in the store and took an active part in getting to know his customers personally. When the local mall opened with plenty of parking, Pop could see the need for change and purchased some land on the street directly on the route to the mall.

With the new location in the growing part of town, Pop thought he was all set. He built a new store with adequate parking and a much larger merchandising area. Pop prospered and so did the area until the street became so busy that customers had difficulty turning into his entrance. Soon they patronized other variety stores instead. Pop put in a second entrance on the side street nearest his store and it helped a little. However, these changes did not accomplish their goals and eventually the business became unprofitable.

Notes from the Case Studies

1. A business location must be easily **accessible.**
2. A business location needs to be where people travel.
3. A business location needs to be visible.
4. Better locations command higher rents.
5. Other businesses in the area help develop store traffic.
6. Location should be carefully researched before making a selection.
7. Location within a city may be more important than the city itself.
8. A change in location may discourage loyal customers.
9. Traffic can be a detractor as well as an advantage.
10. Knowing when to make a location change is an excellent management skill.
11. Profitability depends on many factors besides location.
12. Convenience is an important element of location.
13. The quality or desirability of location can change over time.
14. Location is more important for some types of businesses than others.

LOCATION! LOCATION! LOCATION!

Is Location Really That Important?

One longtime saying in business has been, "In business three things are important: location, location, and location." Perhaps the study of Pop's Variety Store and Carl Miller's experience illustrate a number of the following important location principles:

1. Public transportation or adequate parking in the area is essential.
2. Easy, safe access is a must.
3. **Visibility** is important for drop-by business.
4. Customers demand convenience.
5. Related businesses build store traffic.
6. Business locations must meet local ordinances.
7. Some businesses must locate near sources of supplies or raw materials because of transportation costs.
8. Competition influences the quality of a location.
9. Location costs must be balanced with benefits.
10. **Zoning laws** affect business location.
11. Growth and expansion should be considered in location.
12. Customer demographics may be important in location.

Business Type and Location

The influence on location by the type of businesses in an area can be illustrated by considering the annual back-to-school shopping of many parents with rapidly growing children. If you are the **proprietor** of a children's shoe store your traffic will likely be greater if you are located near children's clothing stores than if you are near automobile parts stores. By the same token the auto parts stores would be in a better location if they were in the area of other auto-related businesses.

A college book store would appeal more to students if it had an on-campus or adjacent-to-campus location rather than a business district location. According to research, **destination trips** account for as much as 25 percent or more of sales in some businesses, but do not usually provide the bulk of store traffic. Perhaps the biggest exception to that reported research would be the grocery stores, they enjoy a higher rate of destination shopping than most other stores.

Some businesses do not need to attract customers to the headquarters location, thus do not need to spend as much effort to solve the location puzzle. For example, a well-drilling business might need yellow pages-type advertising and a telephone service. Another example might be a manufacturing company's production location – their concern would be shipping and receiving.

Traffic and Location

Our case studies illustrate both good news and bad news about location and traffic. On one hand, increased traffic brings more potential customers by the store; on the other hand, too much traffic can discourage potential customers.

How can you balance the two? One successful business provided a partial solution by obtaining a second entrance from a more lightly traveled side street that had a stop light on the main thoroughfare. This provided a safe entrance to the business. Other businesses try for a corner location, thus permitting direct access from two sides. Traffic lights provide a break in the traffic flow allowing turns onto the business location.

In mall locations foot traffic is the concern. Mall developers like to obtain **anchor stores** at the mall ends, thus encouraging shoppers to pass the other businesses in the mall. As a prospective business operator within such a mall, your location goal is to find a strategic location based on traffic generated by "key" stores; other complementary businesses; or factors such as food, comfort, and entrances into the parking lot.

Customer Profile and Location

Perhaps a good illustration of this concept would be the current development of factory-outlet malls. These appear near heavily traveled interstate highways. They are aimed at the traveling public, people who are traveling and probably have money to spend on discounted name brands. Another example would be the location of antique dealers in the restored historical sections of some cities. These merchants are counting on customers who have an interest in historical things.

You seldom see a successful antique dealer surrounded by shoe, grocery, or variety stores. Antique shoppers do not, as a rule, shop for groceries and antiques at the same time. A knowledge of your potential customers and their buying habits will be useful in decision making.

Is the High Rent District Worthwhile?

Knowing when a rent is too high or when it is justified is an important management decision point. How do you determine the answer? At best it is a risk an entrepreneur has to assume. A small entrepreneur located his beginning business in a developed area adjacent to the university campus. In order to obtain his very modest store space, he had to sign a multi-year lease at a substantial rent figure. He had outgrown his garage, but was not sure he had grown into the new location comfortably. His hours in the shop were too long, and the business hadn't grown enough to hire full-time help. As a result he was suffering from "burnout."

Perhaps some common sense questions can provide guidance on this question. Consider the following:

1. Have the other tenants in the area been there a long time?
2. Have similar business prospered in the area?
3. Are the landlords concerned about their tenants' well-being?
4. Are the properties well maintained?

If rents get too high, businesses move or become unprofitable causing volatility in the area. Prosperous businesses indicate stability. Landlords who maintain their business properties and are concerned about their tenants, indicate a mutual interest in profitability.

Summary

Site selection is important to the well-being of most businesses. Your selection criteria will likely involve some or all of the following items:

1. Accessibility
2. Atmosphere of the area
3. Businesses in the area
4. Direct and indirect competition
5. Traffic
6. Zoning restrictions

After you determine your criteria, research favorable sites or locations and rate each based on the importance of each criterion to your business.

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4. Meyer, W. G. *Retail Marketing,* 9th Edition. Gregg Division McGraw-Hill Book Company, 1993. pp. 552-530.
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FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Select two similar businesses in different areas and observe (count) the traffic going by for 30 minutes at several different times during the week.
2. Discuss the results of your observation with others.

Activities to Aid Decision Making

1. Determine the rent at each location in the first activity and relate it to the apparent business activity.
2. Do a traffic count at possible sites for your chosen business.
3. Visit your city building and obtain traffic count information about your chosen business locations.

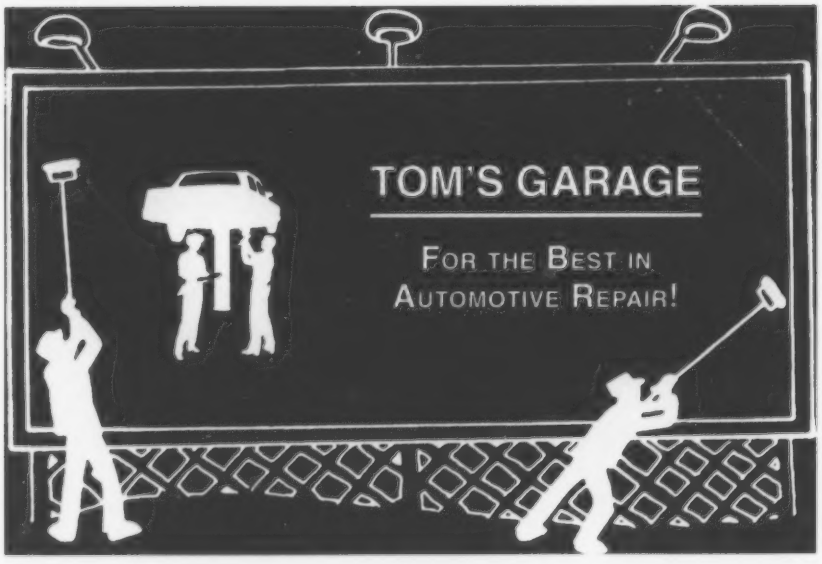
Questions to Increase Your Understanding of the Text

1. What are the three most important concepts in business location?
2. How does customer profile influence desirable location?
3. How do related businesses aid location?

Questions to Aid Decision Making

1. Will my business location help me pay the required rent?
2. Will this location be convenient to my customers?
3. Will this location permit expansion and growth?
4. Will this location provide visibility?
5. Will there be adequate parking at this location?
6. Will there be safe access to this location?
7. Will this location grow or decline in importance?

PART III



Marketing Your Product or Service

CHAPTER 7

Becoming a Competitor

CHAPTER GOALS

- To identify ways of competing.
- To identify competitors.
- To identify a competitive advantage.

KEY CONCEPTS

Added value – A product is changed or improved for resale at a higher price.

Competitive advantage – Anything that permits you to maintain or improve your share of the market such as location, lower costs, better quality, or service.

Cost competitive – Cost of a product is below a competitor's.

Demand – A schedule of the amounts of goods or services that customers are willing to buy at given prices.

Demand shifters – Things that change the amount of goods or services customers will buy at a given price.

Elastic demand – When a change in price makes a big difference in the quantity that customers are willing and able to buy.

Inelastic demand – When a change in price makes little or no difference in the quantity that customers are willing and able to buy.

Labor intensive – A product or service that uses much labor and not much money.

Location – Where a business is physically located.

Low-cost producers – Producers whose costs are lower than their competitors.

Price lining – Providing various qualities at different prices.

Service – Value-adding customer aid beyond just supplying goods.

Supply – A schedule of the amounts of goods that producers are willing and able to supply to customers at given prices.

Supply shifters – Things that change the amounts of goods or services offered at a given price.

CASE STUDY

Dick Makes Caramel Corn Sweeten His Purse

While in junior high school Dick started looking for an agricultural project that he could use to become a member of his local FFA chapter. With guidance from his future vocational agriculture teacher he decided to grow popcorn on empty lots near his home. The popcorn grew well and in the autumn Dick watched the moisture content closely in order to have a top product.

His classmates asked for "taste test samples." Being a practical young man, he thought offering samples might be a good way to generate some sales. After a discussion with his mother they decided to do the job in style and made a large batch of caramel corn that Dick shared with the other FFA members at their next meeting. One of the members suggested that if Dick processed his product this way and sold it, he would more than double his income.

After calculating his costs, Dick decided to **add value** to his popcorn by marketing caramel corn. During the following Christmas season his caramel corn was a hit at numerous parties. Dick was soon busy making and selling caramel corn. With experimentation he improved the recipe and the marketing techniques. Dick paid for his university education as a result of this enterprise.

Notes from the Case Study

1. Dick added value and was rewarded for that **service**.
2. Free samples can effectively introduce a new product.
3. Dick competed by providing a lower cost substitute.
4. Controlling your raw materials improves quality and profit potential.
5. Many young entrepreneurs get their start with a small project.
6. Low-tech items and procedures can be profitable ventures.
7. Dick benefited from a **labor-intensive** enterprise; he realized an additional reward for his otherwise under-used time.
8. Dick's initial investment was quite low as he used family resources.
9. Dick developed customer loyalty by constantly improving his product and service.
10. Dick's business was home-based.

COMPETITION

Surveying the Competition

Competition is the reason for studying the market and a number of ideas are presented in the market research section of Chapter 8. Read that section along with this chapter.

We have the freedom to enter or leave a business competition field at will. However, we may not be able to do so on a practical basis. In the early 1900s there were many automobile manufacturers. Cars were built in bicycle shops, buggy shops, and many other facilities. Today we have the freedom to enter the automobile manufacturing business. However, to obtain the volume of business necessary to be **cost competitive**, you would require enormous capital to fund plants, research and development, design, and advertising.

Economics is defined as "the study of how people trade with each other locally and globally." The better you understand how to do this with your product or service, the better you can predict how to act in the future and change your practices to maximize profits and other rewards.

DEMAND

People buy more of a product or service at lower prices than at higher prices. As an example, there are more Chevrolets, Fords, and Plymouths on the road than there are Cadillacs, Lincolns, and Imperials. **Demand** refers to the amounts of products or services that people are willing and able to buy at each of several prices when other things remain unchanged. Various combinations of quantities taken at various prices are called a **demand schedule**.

Since some goods and services are extremely important to us, we may be willing to pay almost any price for that item. For a diabetic, insulin is a good example of this principle. The diabetic must have it, but will not buy more at any lower price. We call this a product with an **inelastic demand**. For a product with an inelastic demand, the amount needed is independent of price.

However, automotive makes are said to have an **elastic demand**. A change in price in one make of automobile may cause the numbers sold to change considerably. Why? One make of automobile makes a good substitute for another.

Also consider the situation for sandwiches. A slight increase in hamburger prices may cause hamburger eaters to eat hot dogs instead. A large change in quantities purchased may be the result of the small price change as hot dogs are substituted for hamburgers. The demand for hamburgers is said to be elastic because a small change in price brings about a large change in the number of hamburgers consumed.

How elastic is the demand for your product or service? You won't know the precise demand schedule for your product or service. For example, if you knew the whole demand schedule for donuts, you would know how many donuts could be sold at various prices. If you also knew your costs for making various quantities, you could calculate the price at which you would make the most money. This is what you try to do. However, without complete information, you are never quite sure you succeed.

When a different quantity is taken at the same price this produces a shift in the demand schedule. **Demand shifters** include changes in population, changes in per capita income, changes in product substitutes, changes in the price of substitutes, and changes in expectations. Just knowing about demand shifters will help you explain, understand, and account for why you were able to sell different numbers of donuts at the same price as before.

Spend some time and effort at improving your understanding of the demand for your product or service. With your greater knowledge, you'll be better able to predict how many units you can sell at various prices. Your new insight will probably cause you to change your prices as you seek ways to increase your profit.

SUPPLY

Supply describes the amounts of goods or services that producers are willing and able to make available at given prices. Quantities supplied will increase when prices of the product are higher. Producers can pay more for their supplies and the services needed to make the product or render the service.

When others see a profit potential they may decide to enter the market and compete for the profits. To remain in the market, an entrepreneur needs to establish a sustainable competitive advantage.

The supply of goods available at any given price depends on the producer's costs. Some producers have lower costs than others. They may own the raw materials just as Dick grew his popcorn. Or they may use or manage their resources more efficiently.

Will you be a **low-cost producer**? Keeping costs low is very important if you expect to remain in business. How can you be more efficient in order to lower your costs? The answer is two things:

1. Have you picked the right recipes?
2. Do you make the recipes right?

We have described a supply schedule as the quantity of goods marketed at various prices. Having said that, we now need to recognize that there are also **supply shifters** that affect the supply at a given price. Some of the more easily recognized supply shifters are the advances in technology, changes in the price of a resource used, or a change in the price of a substitute.

Again, our advice is for you to become a serious student of your industry's production practices and the costs of your competitors. Learn what they do and find ways to copy their cost-cutting practices in order to become a low-cost producer.

YOU CAN'T TELL THE PLAYERS WITHOUT A SCORECARD!

Once you have decided on the nature of the business you wish to enter and know who the potential customers are, you need to know who the competitors will be.

Competition in this case, can be defined as people who make or sell the same goods or services, as well as those who supply substitutes. As an example, I bought one brand of shoes for over 30 years because of comfort and quality. During that time period this model went from $26 to $116. When the hi-tech cushioned joggers came on the market and competition dropped the price to under $20, I tried them and found I liked them! I now save the former brand for dress occasions.

In the market research section of Chapter 8 we deal with researching the competition as a part of identifying your market potential. Read that chapter in conjunction with this chapter.

SOURCES OF INFORMATION ABOUT COMPETITION

Where can you find out who you will be competing with for customers? Remember, even if yours is a completely new product or service, you still have to compete with others for the customers' dollars. Some sources of information about the competition are the following:

1. Yellow pages
2. People in the business
3. Local Chamber of Commerce
4. Trade newspapers and magazines
5. Financial institutions
6. Suppliers
7. Customers
8. Small Business Development Centers
9. Personal observation

Ways of Competing – Price, Quality, or Service

PRICE

Some producers have lower costs than their competitors; therefore, they have a competitive advantage in pricing. This advantage may stem from location, control of their basic resources, lower labor costs, or a host of other factors. Dick had all of these advantages. Young people often can compete in labor-intensive enterprises because they have more "muscle time" available.

QUALITY

As mentioned previously, the concept of quality is sometimes in the eye of the beholder. Clothing merchandisers frequently recognize this factor and adjust their marketing strategy. They carry three or more lines of clothing: the economical for the very price-conscious purchaser, a middle quality for those who want a better grade, and a higher quality and priced line for those who put quality above price. This is called **price lining**.

The difference in quality in the three lines can be described as the quality of the cloth, the cut, and style. Quality in automobiles may be reflected in more comfortable seating, greater leg room, extra safety features, and similar items. Think of examples in other industries.

SERVICE

Some businesses insist that instead of **location, location, location** as the key to business success, it should be **service, service, service.** Currently the most successful merchandising chain emphasizes service in the training of all of its people. One large employer uses a checklist after an interview in order to estimate the applicant's service potential for the company. With the items in the list the interviewer tries to identify people skills and a willingness to go the extra mile. We will discuss this more in another chapter.

Service by a business may be the reason you trade with some businesses and not others. Think about it, can you name a business that you enjoy doing business with so much that you will drive by its competitors in order to reach it? Why? Is it price, quality, or service?

OBTAINING AND SUSTAINING A COMPETITIVE ADVANTAGE

What will be the situation with your product or service? Will you have a location advantage? Do customers currently drive long distances for the goods or service you are going to offer? If so you may have a location advantage that will give you a cost advantage.

Any advantage in competition probably enters into the pricing system. Sustaining the **competitive advantage** takes effort on the part of the entrepreneur. Perhaps you can figure out how your customers can add value to their businesses or their personal lives by using your product or service. Some additional suggestions for consideration:

1. Provide more product or service than customers expect, they will love you for it.
2. Learn your customers' names.
3. Learn how they use your product.
4. Provide information on how your product can improve that use.
5. List other products that can aid their use.
6. If your store doesn't have the item, refer them to the one that does.
7. Greet your customers.
8. Smile, it is an oil that lubricates human contacts.
9. Respond quickly to a request for help.
10. If you don't know an answer, volunteer to obtain the information and report back immediately.
11. Follow up all sales and inquiries.
12. Train all your employees in these skills.
13. Reward good service from your employees.

Some artisans create handmade unique products that are sold at premium prices. They have the most easily sustainable competitive advantage.

Many of you will, no doubt, start your businesses as home-based businesses. This may or may not be a sustainable advantage. It may be an advantage due to your lower fixed costs until you outgrow the location or the location itself becomes a deterrent to growth.

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FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Select a product or service and research how many businesses compete in a 25-mile radius.
2. Select a few retail items and compare the competition on price, quality, and service in several stores.

Activities to Aid Decision Making

1. Research the number of your competitors from the yellow pages of your local telephone directory.
2. Identify your competitors' areas of competition. Are they in price, quality or service?

Questions to Increase Your Understanding of the Text

1. What do we mean by a consumption decision?
2. What is a demand schedule and how does it affect your pricing?
3. What is a supply schedule and how does it affect your pricing?
4. What is a competitive advantage?

5. How does one sustain a competitive advantage?
6. What are demand shifters?
7. What are supply shifters?
8. How does a business reduce costs?

Questions to Aid Decision Making

1. What is your competitive advantage?
2. How can you sustain that advantage?

CHAPTER 8

Studying the Market Place*

CHAPTER GOALS

- To develop your understanding of market research.
- To develop your ability to identify a market niche.
- To help you identify ways of doing market research.
- To help you develop your market research questions.

KEY CONCEPTS

Business plan – A detailed written plan for operating a business venture.

Competitor – A business that sells the same or similar products.

Customer profile – Demographic information about customers.

Inferential data – Assumptions based on other data or observations.

Market niche – A specifically defined portion of a market.

Market penetration – The ability to gain an increasing share of a market.

Market research – Gathering information related to promotion of a given product.

Overhead costs – Fixed costs of doing business such as rent, utilities, or other ongoing costs.

Primary research – Data you gather for yourself.

Propagating – Growing or reproducing.

Secondary research – Data gathered from existing data sources.

Standard and Poors Directory – An important business reference.

Test market – Trying out a product on a limited basis to see if it can be profitable.

*By Janice Fleenor Smith

CASE STUDIES

Plants from Beginning to End

Joe and Nancy enjoyed indoor gardening as a hobby for years and were successful in **propagating** even the most difficult plants. Upon retirement they invested some of their savings and purchased the necessary supplies and materials to establish a small retail shop in a local strip mall which was open from 9:00 a.m. to 9:00 p.m., Monday through Saturday.

They purchased their exotic plants from wholesalers and propagated most of the plants from cuttings. They offered a line of containers and carried a small stock of gardening tools and indoor grow lights. After a request from one of their customers, they also obtained a few books on indoor gardening to help their customers know how to care for the plants they purchased.

Although dedicated to excellent customer service and popular with their customers, Joe and Nancy were forced to close their business after six months because they weren't generating enough income to meet their business expenses.

Sam Sews Santas

Sam, as she was known affectionately by her friends, faced a dilemma. Her last daughter had just completed college and was employed in a distant city. Her husband died unexpectedly, leaving her with an inadequate insurance policy, a mortgaged home, and little in the savings account.

Sam had been a school teacher but there were no openings in the area. She was an excellent seamstress and did the mending and alterations for a neighbor who owned a laundry business. Sam did not want to enter the labor market. She was searching for ways to earn the additional income needed to keep her comfortable home in a neighborhood she loved. One day while repairing a well-worn Santa Claus suit she had an idea.

Sam took orders and made custom Santa Claus suits for $400 each. She converted her two empty bedrooms into her sewing area and kept busy. She had a competitive advantage in that she used her home to reduce **overhead costs**; she also had a low inventory and minimum risk. Her materials were purchased after the customer placed an order.

Sam found a good **market niche**. She did not have to compete in a clothing business where large manufacturers cut thousands of garments at once.

Notes from the Case Studies

1. Joe and Nancy failed to do their **market research**.
2. Market research is an essential planning activity.
3. Market research is a vital part of a **business plan**.
4. Enthusiasm is not enough to create a profitable business.
5. Identifying a market niche is good market research.

6. A part-time activity can grow into a business.
7. A competitive advantage is more likely with a market niche.
8. Too often beginning entrepreneurs consider finances the most important preparation.
9. Market research must precede informed decision making.

MARKET RESEARCH

Identifying a Market Niche

Sam, without being aware of it, successfully identified a suitable market niche. A market niche can be defined as a situation or activity specially suited to the abilities or character of a person's business. Often it is found in products or services the large national retailers do not offer.

Finding the right market niche is not just a hit-or-miss happenstance as it was with Sam. Finding the right market niche is a result of careful market research.

Look at many of today's national franchises. They occupy well-defined market segments. Burger King, Dairy Queen, and McDonald's are examples. McDonald's selected the target group of people who want wholesome food fast, rather than take the time for a leisurely meal in a competitor's restaurant.

McDonald's continually conducts extensive research. For example, they have expanded their niche to include breakfast menus. They even **test market** new products in selected stores before deciding to add items to the menu of the national chain of restaurants.

Think of your niche or your piece of the pie, Figure 8-1.

Figure 8-1 My market niche

The Purpose of Market Research

Research provides you with information which you use to improve your decisions. It allows you to put yourself in the minds (or shoes) of potential customers. It allows you to know which goods or services to offer and how to do so in a way which will prompt customers to buy from you, rather than competitors. To be "market-driven" means that you identify an unsatisfied or undersatisfied need in the marketplace which you then decide to fill using all available resources and experience, but only if you can do so at a profit.

Your marketing plan is a large and important part of your business plan. The marketing plan for your business should include the who, what, when, why, and where of operating your business. Research to answer each of these questions should become a regular part of your everyday activity. You need to refine both your business and marketing plans frequently as a blueprint for your efforts and the measure of your success.

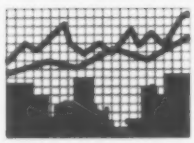
A few of the questions which Joe and Nancy failed to obtain demographic information about follow:

1. Who buys house plants? What sex, age group, and characteristics are shared by such buyers?
2. How many people are there in the area in which the business is to be opened fit the profile developed in answering question number one?
3. Where do these potential customers currently buy their plants? How much do they pay for them? What other products do they usually purchase when they buy plants? How much do they spend? How often do they purchase?
4. Who are the local competitors? What are their business hours? How do they advertise? What are they offering in addition to plants?
5. What are the full costs for the products to be sold? The costs of doing business such as rent, utilities, transportation for both owners to work, as well as their food and miscellaneous expenses should be recouped in addition to the cost of the plants, supplies, and inventory. As self-employed owners, taxes and salaries must also be covered. Will the price they must charge to be profitable also be a competitive price?
6. Can Joe and Nancy support the business and themselves from savings until such time as they can expect to generate a profit?

What Is the Purpose of Market Research for Your Company?

1. Market research will help you recognize, establish priorities for, and seize profitable opportunities.
2. Research helps you identify problems, develop solutions to those problems, and verify information on which to base decisions.
3. Research increases your ability to draw realistic conclusions and make decisions with knowledge of risks and consequences; and it helps you evaluate priorities and alternative solutions.
4. Perhaps most important: research creates and helps you maintain a channel of communication between you and your marketplace.

Types of Market Research Projects



Research projects are limitless. Depending on the decision to be made, they include the following:

1. Research on competitors
2. Business and economic climate
3. Sales and **market penetration**
4. Product development
5. Communication effectiveness studies
6. Price and cost analysis
7. Distribution methods
8. Location viability
9. Customer preference studies

At the *very least* you should research the following:

1. Who and how many potential customers are available to purchase your products?
2. What products do the potential customers need or want?
3. How should the products be packaged and presented?
4. Why are customers currently buying from competitors?
5. At what price do they purchase the products?
6. When do they purchase the products?

Learn all you can about your potential customers and the marketplace in which you plan to do business before deciding how to conduct your own business. Consider how you might create a competitive advantage: will you meet customer needs better? More cheaply? Or both?

Secondary or Primary Research – What's the Difference?

Secondary research is the review of information already available as a consequence of being collected for reasons other than your specific need. This may be information in the following:

1. Phone books
2. Trade and professional directories or publications
3. Economic and business data available through universities
4. Chambers of Commerce or other organizations
5. Newspapers
6. Annual reports
7. Tax publications, and similar publications

Also research the following internal business records concerning your customers:

1. Sales
2. Costs

These are all useful in a variety of research projects undertaken in order to make informed decisions.

Primary research involves contact with people through observation, written or verbal surveys, focus groups, and direct face-to-face communication to obtain specific information.

It usually requires both kinds of research to develop all of the information required to complete the essential research. We have already mentioned identifying who your customers or clients are, or are likely to be, and how best to make your offering to them.

How to Begin

Start with your competitors. Complete a market research questionnaire for each competitor. Duplicate and use Figure 8-2, at the end of this chapter. Create a file for each business from which your potential customers can buy products to fulfill their wants or needs that you hope to satisfy with your own products. Consider yourself a detective and constantly pursue information. Collect newspaper advertisements and news items. Customer and competitor research should be an ongoing part of your daily operation. Files for such information can be important in decision making.

Remember you cannot gather all the items about every competitor and you probably couldn't afford the time even if the information were available to you. However, the information you can gather will help you in your marketing efforts.

To be successful in business you must avoid or correct the weaknesses of your competitors, and meet or exceed their strengths. In learning about competitors, you learn about their customers who will, hopefully, become your customers. This is especially important for start-up companies who may not yet have customers who can provide information needed to develop a "**customer profile**."

Other Sources of Market Research

Market information is readily available. Begin with the research librarian at your public library. Work from the outline provided in Figure 8-2 and seek the information about your competitors.

Newspapers, magazines, books, and directories offer a wealth of information. Newspapers, for example, contain information on business and society leaders in your community who can give you insight on the qualifications of the management team of your competitors.

Advertisements can give you business hours and locations, prices, products offered, special sales or terms, and often, trade affiliations of your competitors.

Professional and trade directories often provide detailed information as to the sales volume, net worth, number of employees, credit rating, and the identities of top managers of companies.

Other resources for your research projects are the Chamber of Commerce, SBA, and SBDC. They assist entrepreneurs through consultations with SCORE personnel who are retired executives providing counseling services. In addition they can answer questions about the local business environment and identify and describe local businesses (including your competitors). They can also assist you in communicating with the Small Business Administration and other federal or state business resources.

You can visit your competitors as a customer to assess firsthand their way of doing business; Sam Walton did! You can also question friends or relatives who have done business with these competitors. This is a very useful research approach because you learn about the competitors, and you are talking to a customer who may one day be yours. You can ask direct questions about their needs and preferences. Filling those needs and meeting those preferences will entice them to become your customers.

Your potential or current suppliers may be selling their products to your competitors. If so, you can learn a lot from some discreet questioning during the course of routine sales calls. The same is true concerning media sales representatives. Newspaper and radio sales people often want to prove the effectiveness of their coverage by telling you success stories about their clients. If your competitors are among them, you can gain valuable information by asking them to demonstrate how well their campaign or ad worked for a competitor.

Applying the Research

How you analyze and implement the data depends on the business decision you are trying to make. Statistical information is useful when the decision can be based on numbers such as how many customers are available, how much they spend, how frequently they spend, and how much something costs to produce versus how much customers are willing to pay.

Inferential data is less concrete. It involves understanding, assumptions, experience, historical and future trends, and opinions. This kind of information is the type used to develop a picture of the characteristics or "profile" of your potential customers.

Understanding what characteristics the majority of your customers share helps you decide how to price, package, promote, and sell your products in ways most appealing to the type of person who buys from you. Learning about why your current customers buy from you helps you focus your efforts on attracting new ones.

Market research is not difficult if you adhere to the following guidelines:

1. Start where you are with what you already know.
2. Review the known facts.
3. Identify what additional information is necessary to help you make an informed decision.
4. Never make decisions for your business without making the effort to gain as much information as you can.
5. Remember, uninformed decisions may end up costing you money, and maybe even your business!

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FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Visit your local library. Ask the research librarian to show you how to locate and/or use some of the following resources:
   a. *Standard and Poors Directory*
   b. Your local city directory
   c. An industrial guide for your area or state
   d. Any economic reports for your area or state
   e. Files supplied by the Chamber of Commerce
   f. Back issues of your local newspapers for the previous thirty days
   g. Annual reports and/or newsletters published by local businesses and/or businesses similar to your own
2. Arrange an appointment through your local Chamber of Commerce to meet with someone on their staff and discuss the following items:
   a. Discuss the business climate in your area. Obtain information concerning those resources available to you.
   b. Ask for introductions to chamber members who can help you decide whether to join. Arrange to attend a social after-hours meeting and talk with members about their businesses as well as learning what you can about competitors. Seek introductions to professionals who will be helpful to you such as bankers, accountants, attorneys, and marketing professionals. Don't neglect the opportunity to meet and talk with competitors.

Activities to Aid Decision Making

1. Begin your own market research with the yellow pages and do a questionnaire for each competitor.
2. Write out the decision(s) you need to make as clearly as you can.
3. List all the information you require before you can make an informed decision.
4. List all the sources of the information you need.
5. Establish a priority for the steps to be taken.
6. Open separate files for collecting information about each of your competitors and customers now, so you have a central collecting point for all new information you obtain in the future.
7. Get started. If possible, do much of this research while still employed elsewhere.

Questions to Increase Your Understanding of the Text

1. What is market research?
2. What is secondary research?
3. What is primary research?
4. Why conduct market research?
5. What are the advantages of conducting the research?
6. What are sources of market research information?
7. How does one apply research results?

Questions to Aid Decision Making

1. What market research is most appropriate to your business activity?
2. Which sources do you need to research?

Market Research Questionnaire

Name of Competitor:

Mailing Address/Phone:

Other Locations:

Products/Services:

Owner's/Manager's Names:

Names/Titles of Key Personnel:

Number of Employees:

Number of Salespeople:

Method of Selling (Direct? Distributors?):

Estimated Annual Sales:

Estimated Market Share:

Estimated Sale Per Customer:

Inventory Level/Turnover Ratio:

Size of Physical Operation:

Condition/Appearance of Facilities:

Year Business Established:

Geographic Area of Activity:

Method of Delivery to Customers:

Reputation in Community:

Terms and Conditions of Sale:

Credit Arrangements:

Costs of Production or Distribution:

Name/Location of Major Suppliers:

Profile of Typical Customers:

Figure 8-2 Market research questionnaire

Market Research Questionnaire *(continued)*

Size of Customer Base:

Guaranties/Warranties:

Return Policies:

Damaged Goods Handling:

Restocking Charge Practices:

Customer Service/Order Entry Policies:

Strengths/Weaknesses of Personnel:

Strengths/Weaknesses of Production:

Strengths/Weaknesses of Delivery Methods:

List of Known Customers:
(Names/addresses/items purchased/common characteristics/frequency of purchases, and similar information)

List of Past Customers/Reasons for Loss:

Available Financial Information:
(Bank used/accountant/items leased/items owned, and similar information)

Identity of Business Associates:

Membership in Professional/Trade Associations:

Internal Training Practices:

Advertising Activities:
(Type/frequency/media used/samples of ads and dates used, and similar information)

Promotional Activities:

Trade Show Participation:

Business Hours:

Other:

Compare all the facts above with your own business to identify differences and determine affirmative action.

Figure 8-2 Market research questionnaire *(continued)*

CHAPTER 9

Pursuing Positive Publicity*

CHAPTER GOAL

- To identify ways to publicize your business.

KEY CONCEPTS

Feature story – A news story about a particular item or person.

Private showing – By invitation only.

Open house – Inviting the public to see the business.

Publicity – Bringing to the public's attention.

Shoestring – Very limited budget.

Studio – Artist's work area.

CASE STUDY

Getting the Word Out

Steven's **Studio** was open for almost a year on weekends and evenings before he quit his job and started to operate as a full-time business. He had a good following for his pottery among attendees at craft shows, community festivals, family, and friends. Whenever they were displayed, his unique products attracted customers.

Steven was operating on a **shoestring** and couldn't afford to place ads, but he needed to get the word out that his pottery was now readily available at a regular retail location. He decided to take advantage of "free" **publicity**.

Listing all the names and addresses of his customers, friends, and relatives, he called and invited them to a **private showing** of the newest designs and a tour of his new shop. He asked each of them to bring a friend, preferably someone who enjoyed pottery and crafts.

Next, he told them that two drawings would be held for one of his special items. One drawing for everyone who attended, and another for those people who brought a guest. The drawings were made from cards which attendees filled out when they arrived.

*By Janice Fleenor Smith

The information requested was name, address, phone number, and whether they had ever purchased pottery in the past. He also asked what item was their favorite of those on display in the shop.

Next, Steven contacted the local newspaper and spoke with the business news editor and feature story writer to try to interest them in giving his open house and new business some space.

The business news editor promised to include a notice of the date and time of the grand opening in the news calendar section of the paper. The feature story writer agreed to consider a short article. She asked Steven to submit a letter outlining some of the facts about his business and his background, and to include some special interest feature in the story.

Steven contacted libraries, schools, and some businesses he knew that had lobby display cases appropriate for displays, and offered to design and set up a display of his pottery along with small display cards giving information about pottery or the historical aspects of pottery. The library agreed to his proposal.

Contacting several local merchants, he found two who were willing to let him place a notice concerning his grand opening on their bulletin boards. He placed the same notice on public bulletin boards wherever he could find them, including nearby car washes, laundromats, and the lobby of his apartment building.

Finally, Steven contacted the craftspeople and artists he knew and invited them to attend his open house. He asked each to display one of his items in their shops or craft show booths and refer customers to his shop. In return he would give them a substantial discount on his merchandise.

Notes from the Case Study

1. Publicity is money-free promotion.
2. Time and effort can be substituted for paid advertising.
3. Adding educational features got a display in the library.
4. Steven networked with other craftspeople.
5. **Open house** events attract attention.
6. Business news columns often cover start-up businesses.
7. **Feature stories** can be free publicity for a new business.
8. Imagination can create favorable attention.
9. Door prizes attract store traffic.

GETTING FREE PUBLICITY

Public Relations Activities Are Ongoing

You can promote your business with little or no money. You substitute personal effort and imagination for the money you lack.

Start-up companies usually concentrate a tremendous amount of effort on developing good public relations because they have little money to pay for paid advertising. Huge corporations focus great attention on public relations because they recognize how vital it is to them to maintain their favorable image in the public arena. All companies should make public relations and publicity activities a key element in their marketing communications plans.

People buy from people. Making sure that people (your customers) recognize and appreciate the people behind the business is vital. Their recognition and appreciation translates into your reputation in the marketplace.

Maintaining good relations with customers and with the general public in your community is as simple or as complicated as you make it. Advertising is a message which you pay to place before the public. It is supported only by the credibility you have built in the marketplace. The public is often skeptical of the accuracy or truth of the message in advertising. They take it "with a grain of salt."

Publicity about you or your company is a message for which you do not pay, which is distributed on the strength of the credibility, reputation, and worth of the person or organization which makes the statement. With nothing for them to gain by saying something positive about your company, they are considered a disinterested third party whose words are factual. Such third-party statements carry much more weight with the public than do your own statements.

Publicity, excellent customer service, public contact by managers and employees of your company through professional associations and community service, and networking are all very useful methods to be employed in building awareness of your business in your community.

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FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Scan several back issues of your local newspaper and identify the business activities calendar, stories or announcements of new business start-ups, grand openings, open houses, customer appreciation days, promotions, transfers, and similar items.

2. Try to locate advertisements placed by any of the companies who were mentioned in the business news section. Are there connections between the products or services mentioned and the news topic?

3. Collect company newsletters which are sent to customers or clients. Review them to see how the business informs or educates their readers about their contribution to the local community through support of education and worthy causes.

Activities to Aid Decision Making

1. Develop a list of friends and associates who would be helpful in making referrals for your business.

2. Try to identify ways in which you could be useful to them in exchange for their efforts on your behalf.

3. Develop a network for mutual benefit.

4. List the names of trade, social, and community groups to which you belong or have a connection through a member. Find out which group uses speakers as a part of their meeting. If appropriate for you, contact the club's program chair and volunteer to address the group on a topic in which you have expertise. Pass out your business cards by way of your introduction.

Questions to Increase Your Understanding of the Text

1. List the techniques Steven used to obtain publicity.

2. Why are third-party recommendations more powerful than advertising?

3. Is publicity enough to make your business flourish?

4. What elements does the text suggest be added?

Questions to Aid Decision Making

1. Which of these techniques can I use in my business?

2. What features of my business can I "sell" as a feature story?

3. To which organizations can I present appropriate programs to promote my business?

CHAPTER 10

Advertising and Promotion*

CHAPTER GOALS

- To introduce the concept of advertising.
- To introduce the concept of promotion.

KEY CONCEPTS

Advertising – Paid promotion of your product or service.

Advertising plan – An organized plan for promotion.

Advertising specialties – "Freebies" or giveaway items to promote your business.

Criteria – Specific standards to measure by.

Media – Newspapers, radio, and television are the most common media.

Media kit – Materials promoting advertising in that medium.

Promotion – Activities and events conducted to feature your product or service.

Special interest – A defined group based on some common interest – for example, baseball fans.

Word of mouth – One person telling another.

CASE STUDY

Tom's Growing Pains

Tom's garage grew from a one-person shop, which he operated on a shoestring, to a successful venture with another full-time mechanic and a tow truck operator who changed tires and helped out wherever needed. Customers liked Tom and were well satisfied. Insurance companies and customers both referred new customers his way.

When he started out, Tom confined his **advertising** to "yellow pages" name listings under garage and automotive repair, and to the circulation of fliers and discount coupons.

*By Janice Fleenor Smith

With his evident success, he became the target of **media** representatives seeking ads for local papers, shoppers' guides, radio stations and a cable television company. All of them mailed him letters or called about making appointments.

His phone listing sales representative has just designed impressive display ads and is recommending that he be listed in four categories: garage, automotive repair, tires, and towing. He's tempted to take the telephone ads, but the cost will be $800 per month. The deadline for the phone book is looming, but he can't decide what to do.

Another problem is that he just acquired an expensive piece of equipment for use in straightening auto body frames. It is the only one in his area, and he wants to get the word out about this new equipment that will improve his repair service.

Notes from the Case Study

1. Tom gained customers by **word-of-mouth** advertising.
2. Tom used the "yellow pages."
3. Tom needs additional customers.
4. Tom needs an **advertising plan**.
5. Tom needs a method to evaluate his advertising costs and returns.
6. Advertising and **promotion** may increase cash flow.
7. Advertising is an expense that should be included in cash flow budgeting.
8. Advertising is a unique service.

ADVERTISING

Developing Your Advertising Plan

Satisfied customers willing to make personal recommendations to their friends, and even to their insurance company representatives, helped build Tom's business. Personal referrals are the most effective form of advertising. Yellow page listings showing only his name and address were sufficient for people seeking multiple estimates for auto repair.

Fliers and coupons were distributed by customers and a few friendly, cooperative local service stations that didn't do any repair work or towing. His former high school shop teacher brought in business when he started out, but Tom needs new customers immediately to justify his latest equipment acquisition. How should he reach new customers?

Before committing to any buying decision, you have to determine your objectives in spending the money and decide the best strategy for reaching your objectives. In other words, you need to make provisions in the cash flow budget for your advertising campaign.

Gather information from your market research concerning your current customers needs and desires. Monitor your competitors' activities on the same issues. Use these facts to determine your advertising and

promotional requirements. You already know, for example, what appeals most to your customers about your current operation. You can highlight those facts in your efforts to attract new customers.

You need to consider which media is most likely to influence the majority of customers. Which newspaper is most popular with current customers? What radio station do they listen to? Most people work, so when are they most likely to be listening to their favorite radio station? Are they motivated more by convenience, quality, or low prices?

The answers to those and related questions will guide you in selecting the best media choices. Remember, advertisements are your own messages which you pay to place before the public. The only credibility supporting your message is the reputation of your company.

Try to place your messages in front of people likely to need your services. It is better to place an ad before a small audience of interested buyers, than a larger one less likely to have a need for your services.

Don't be too impressed with the statistics provided by media representatives. Market penetration charts and trade phrases such as "cost per thousand (cpm)" don't have relevance if the majority of the audience has no need for your product.

Media Categories

For our purposes, media can be categorized as print, radio, and television. For most companies, print in all its forms is by far the most important medium. Printed advertising runs the gamut from coupons to telephone book listings, from newspaper ads to product or company brochures, and from trade directory listings to newsletters to box ads in high school sports program bulletins.

All of it can be effective, but it costs money. To select the best channel for your advertising dollar you have to know who you want to receive your message, and what you hope your message will accomplish for your business.

Some examples of questions you need to answer to help you decide on the content of your message and the channel for its conveyance follow:

1. What are the characteristics of your target customers?
2. How old are they?
3. What is their socioeconomic level?
4. What are some common interests?
5. What is their level of education?

Researching demographics helps you determine what type of newspaper, magazine, radio station, or television program is likely to be enjoyed by your targeted customer. There are publications for every known **special interest** and age group. Radio and television programs are always focused on specific groups. Select the media appropriate for your potential customers. Consider the following questions:

1. What is the specific objective for your advertisement?
2. Are you hoping the ads will result in the sale of 10 additional units in a 60-day period?

3. Do you wish to increase the number of customers who visit your shop by 50 and sell to 5 of them during a weekend sale?
4. Do you want to obtain at least 1 referral from each of your existing customers during the next 6 months?

These items are important because you must set up **criteria**, or standards, against which to measure the effectiveness of your advertising project. Your choice of both media and message will be dictated, in part, by the objective. For example, if you hope to gain customer referrals, you wouldn't expect to do so by placing a newspaper ad. You would probably choose to offer an award or discount for each referral made and would need to inform them of that program in a more direct method such as a mailing to each customer's home.

If your objective of selling "X" number of units within a set time period would yield a profit of $500, you probably wouldn't consider spending $1000 a month on large-display advertising in the telephone directory.

How do your competitors advertise their products? Your competitor research files should contain copies of all the ads you have collected, and the ads should show the source and date of each. Analyze the ads and ask the following questions:

1. Are they attractive?
2. Would they motivate you to buy from them?
3. Are they terrible?

An excellent source of information concerning your competitors' advertising programs are the media representatives hoping to sell you. During their sales presentations it is perfectly fair to ask to see typical ads used by businesses engaged in activities similar to your own, including direct competitors.

It is the responsibility of the media salesperson to decide whether it is appropriate for them to share actual ads or specific information about your competitors.

Review ads you have seen or heard which appealed to you ONLY if you are similar to the customers you hope to attract or have currently. You're not writing the ad for you. You're writing it in the way most appealing to your customers.

Most authorities recommend using professionals for the job, but your money is paying for the ads, and you know your customer better than the media representative. Play an active role in developing the content.

NEVER commit advertising dollars without first developing a plan, a cash flow budget, and some method of determining the effectiveness of the advertising project. DON'T expect instant results. Advertising is a long-term investment. Every ad, every brochure, every promotion, and every piece of publicity represents a grain of sand which alone has little impact. However, over time those grains of sand become a solid base which makes you recognizable to the general public.

Budgeting for Advertising

Every business should plan on committing from two to five percent of annual gross sales (or projected annual sales) to its communications efforts. This money will not always yield a return on the investment.

especially in the beginning. Some advertising will result in sales which are directly attributable to the ad. The profits from those sales will pay all or a part of the cost of the ad.

Other advertising dollars cannot be clearly measured. One of the first advertising costs for a new business is with the phone company. Telephone book listings can be extremely expensive, especially in major cities. Few businesses remember to ask new customers whether they used the phone book to learn about the business, so they never know whether the large display ads aggressive sales people convinced them to place are effective or not.

Once committed to a display ad, many businesses fear that to take a smaller ad in a subsequent year will indicate poor business conditions, so they continue a campaign which may not be yielding results for their particular type of company. Unless you know they have been useful in the past, are you wise in placing large display ads under multiple listings?

Establish a routine whereby you ask new customers how they learned about your business. Check the display ads placed by competitors. Be conservative about spending money on media not targeted to the customer base you hope to attract.

Before projecting a cash flow budget for advertising, review the overall marketing and communications plans for your business.

1. What are your business growth goals?
2. How can marketing efforts and communications projects help you achieve your sales and expansion goals?
3. What specific products or services are most important for you to promote?
4. What are the costs associated with the different types of media available to you?
5. How much of your communications budget will be needed to pay for the basic marketing communications materials of well-designed and professionally printed letterheads, envelopes, business cards, order forms, and price lists?
6. What are the costs for invoices, a company brochure for introducing your company to prospective customers, and product packaging when appropriate?
7. How much for sales presentation materials used by your sales personnel if you make direct customer contact to close a sale?

Each advertising project should be a part of your overall plan and should cost no more than you can justify to accomplish the goal of that project. It is better to have fewer projects and do each of them well than to use the "shotgun" approach.

Most advertising is only effective if placed over a period of time at regular intervals. People usually don't focus on ads they see or hear only once. Repetition builds recall which leads to action.

A single message for each ad is essential. Too much information is confusing and people don't pay attention. Promote one theme or one product during each campaign you run.

To reduce costs for print ads, select a visual layout which is consistent for all subsequent ads, but with different messages. Put your company information in the same place, use the same border, select the same type style for each ad, and select two or three sizes which are most useful in the publications you usually choose. Have the ad typeset and produced so that content can be added or deleted. Additional elements can make a new ad, rather than having an entirely new ad layout produced for each project.

To reduce distribution costs for your print materials, solicit cooperation from your suppliers and business associates. For example – ask them to include your print materials in their mailings or display them in their places of business. In exchange, offer to do the same for them.

Promotions: an Added Dimension

Promotional activities such as sales, free gifts with purchases, drawings, contests, and other limited time offers can give a boost to your business if used in conjunction with your advertising efforts.

Promotional activities are successful only if the customers know about them, so plan them carefully to coincide with advertising projects to introduce a new product, or feature a product or service.

The use of giveaway items such as pens, key chains, pencils, baseball caps, and so forth is a common promotional activity. Known as **advertising specialties**, these items, imprinted with your company name and location, are very effective to keep your business name in front of the public over a long period of time.

Advertising specialties yield the best results if the recipients are those who are likely to have a need for your product or service, so be careful about the manner in which you choose to distribute such items.

Current and prospective customers should be your first choice. BE SURE to choose an item which will be desirable and useful to your customer.

ADDITIONAL READINGS

1. Abraham, J. *Money-making Secrets of Marketing Genius Jay Abraham and Other Marketing Wizards*. Abraham Publishing Group Inc., 1994. pp. 272-296.

2. Abrams, R. M. *The Successful Business Plan: Secrets and Strategies*. Oasis Press, 1991. pp. 39-47.

3. Green, D. H. *Consumers in the Economy*. South-Western Publishing Co., 1992. pp. 116-127.

4. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach*. Delmar, 1992. pp. 93-102.

5. Tabak, L. *How to Fatten Your Wallet in No Time Flat!* self-published, 1992. pp. 54-71.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Contact representatives of your local media and arrange to receive a packet of information (known as a **media kit**) from each of them.
2. After reviewing the media kits, make an appointment with advertising sales representatives to obtain the advertising rates.
3. Calculate your own advertising budget.

Activities to Aid Decision Making

1. Analyze the information you gain and compare the audience/reader profile of each medium with the profile of your own current or targeted customers.
2. If you are already in business, survey some of your customers and ask them how they found out about your company. Ask them which papers they read and radio stations they listen to (as well as specific programs and time slots).
3. Develop a rough estimate of the dollars you should commit to advertising and communications efforts based on the two to five percent of gross sales method.
4. Deduct from that budget the cost of basic marketing communications materials listed in this chapter. If you don't have that information, contact a printer and get some rough estimates on the cost of some of these items if printed in quantities of 500 and 1000.
5. Deduct from the budget the cost of your telephone listings. Remember, most phone book ads are payable on a monthly basis, so remember to compute the annual cost. If you haven't already committed to large display ads, limit yourself to obtaining a quote for a name and address listing under any additional categories you feel necessary, and to a small ad under your major heading (and that only if, before calling you, customers need more information about your business other than your location).
6. Divide the remainder of the budget into quarters or by 12 months to allow you to place some advertising throughout the year. With the amount of money available, what is the most important product or service to be advertised? Does promoting this product or service help you meet your overall business growth goals? What specific objective or measure of effectiveness can be established to help you evaluate the success of the media and message chosen? Don't expect miracles. Remember, each advertising project is a single grain of sand, but eventually the ads will begin to meet your expectations if you set a reasonable goal.

Questions to Increase Your Understanding of the Text

1. What is the most effective advertising?
2. How can you evaluate the effectiveness of your advertising?
3. Who should the advertising message appeal to?
4. How can you measure that appeal?
5. Are market research and promotion related?
6. What are the named media categories?
7. What is a recommended advertising budget?
8. Why are your letterheads, sales slips, and similar items considered part of your advertising budget?

Questions to Aid Decision Making

1. What is my targeted audience?
2. Which media is the best to reach them?
3. What advertising specialties are appropriate to my business?

CHAPTER 11

Using Trade Shows And Fairs

CHAPTER GOALS

- To identify ways a trade show or fair can promote your business.
- To identify the principles of exhibits.

KEY CONCEPTS

Center of interest – The main feature of the exhibit.

Cost benefit ratio – Costs as compared to returns.

Exhibitors – Companies or persons promoting products at a show or fair.

Trade show – Marketing aimed at a specific group.

CASE STUDY

Harry Hurries Home!

Harry was the secretary of a newly formed trade association. He and other members of the association were inexperienced in publicity and public relations work and decided to start contacting others at their county fair. They rented a space in the exhibit hall and printed materials intended to attract prospective members. Preparation day came and they set up their table and comfortable chairs hoping that the sign detailing the trade association's goals would attract the attention of prospective members.

When their plans were not working the first regular fair day, Harry quickly saw changes were needed. While another member tended the booth, Harry toured the other exhibits and noted what seemed to be attracting attention for the other exhibitors. Harry hurried home and brought back his son's colorful landscaped model village and toy train set mounted on a plywood sheet. He set the key words of their message on cards attached to each car of the train and set it in motion. Traffic started to increase dramatically at their booth. The following year a much improved booth was designed and built to sell their message. They targeted the people they wished to attract as members.

Bill Buys the Wrong Pitch

Bill and Don had just started an educational materials corporation to market their publications when they were invited to submit promotional and informational materials for a book fair in the university city. The clientele of the book fair were to be the teachers in the area and the prospective teachers in courses at the university. Bill and Don prepared advertising and informational brochures for the expected attendance and put up complete sets of their publications for use as door prizes.

An exhibit booth was set up to display their wares and award the door prizes. The total contact with active teachers was with the single one in attendance. Prospective teachers were made aware of the company; therefore, future business might be a possibility, but in the short run the **cost benefit ratio** was negative.

From this experience they learned to obtain more information before committing limited resources. The next year they supplied informational and promotional literature only.

Notes from the Case Studies

1. Trade shows and fairs must be selected with care.
2. You have limited time to attract attention.
3. Motion attracts attention.
4. You need to define and target your desired audience.
5. You must compete for attention.
6. Details must be limited.
7. Visibility is crucial.
8. Signs must be readable.

TRADE SHOWS AND FAIRS

Choosing Trade Shows and Fairs

LOCATING THE SHOWS AND FAIRS

We have probably all attended a show or fair of some type, whether it has been the annual automobile show in the capital city or the local county fair. Many conventions have a **trade show** in connection with the convention and many **exhibitors** have been there to introduce their products to the specialized group in attendance. Some people spend a considerable portion of their time representing their companies in these shows.

Trade magazines are a good source of information about upcoming shows. Articles and advertisements printed in these magazines mention the shows and provide details about participants – e.g., booth numbers. Attending a show or two before committing your resources to the venture pays dividends. You can see how people react to the different exhibits and demonstrations, and how the products are featured or merchandised. In addition, you can see if the people who attend represent your targeted audience.

Choosing the Fairs or Shows to Target

New businesses are concerned with getting the most for each promotional dollar spent. Selecting the trade shows or fairs to attend can aid the effort or sink the budget. How then do you decide which offer the most return for your time and money? Answers to several questions can help in the decision-making process. Among the suggested questions to research are the following:

1. Is the event within your desired trade area?
2. What was the attendance last year?
3. What is the anticipated attendance this year?
4. What are the featured products and how does yours relate?
5. What are the fees for exhibitors?
6. How does the time of the show fit with other activities?

IS THE EVENT WITHIN YOUR DESIRED TRADE AREA?

If the answer to this question is no, then a second question is essential – will desired customers attend in large enough numbers to make the effort economically feasible? If the answer is yes – consider the timing and location as well as the remaining questions; otherwise, bypass the show.

WHAT WAS THE ATTENDANCE LAST YEAR?

The attendance numbers can be used in the decision-making process in several ways. First, the numbers in attendance can demonstrate the importance of the event in relationship to the time spent in preparation and attendance. Secondly, the numbers give you some help in deciding the budget for the event. Thirdly, the numbers can help you plan for the number of handouts to prepare and the number of people needed to tend the exhibit or booth.

WHAT IS THE ANTICIPATED ATTENDANCE THIS YEAR?

Knowing the number of people anticipated for the year is a reality check on the planning resulting from reviewing past years' attendance.

WHAT ARE THE FEATURED PRODUCTS AND HOW DO YOURS RELATE?

Some products fit into a show sales category more readily than others – for example, if your products are precast concrete items, your expected sales would be less at a sports show than if your product was roller blades or sports wear.

WHAT ARE THE FEES FOR EXHIBITORS?

Fees or booth rentals vary with the show and can be a decision factor for a new company as contrasted to a successful established entrepreneur. Fees should not deter an exhibit, the contacts might launch your company in a successful growth curve. A local auto dealer with a seven-figure advertising budget has stated that half of the advertising dollars were wasted, but he couldn't be sure which half it was.

HOW DOES THE TIME OF THE SHOW FIT WITH OTHER ACTIVITIES?

If the show occurs at your busiest time of year, you must plan more carefully to do both activities well or decide to concentrate on current business.

CREATING EYE-CATCHING EXHIBITS

Choosing the Theme

One principle of marketing is simplicity. With only a few seconds as people pass by your booth to attract your audience the message must be short. Include key words – not sentences – to impact the eyes.

Color attracts more attention than black and white; however, that does not mean any color will suffice. Instead, colors should be in harmony and pleasing to the eye.

Motion is always useful in catching the eye's peripheral vision. It results in capturing the viewer's full attention to check out the motion. This is an instinctive reaction from the time when motion had to be checked to see if it represented a danger. For its most effective use, motion must be related to the message.

Combining these elements into a unified whole or theme is the first challenge of the successful exhibitor. In other words, select the one most important idea you want people to take away from your booth as their first impression of your company. Then sell it effectively.

DISPLAYING YOUR WARES

Helps abound on techniques of effective displaying and effective merchandising. Our comments will be limited to general observations.

Your displays should be arranged so they do not appear to be crowded or cluttered. The eye should be led to the **center of interest** or main feature located 1/3 of the way into the booth. The main marketing feature or focus of the advertising campaign should stand out.

Lettering size is important to visibility, the size should be compatible with the viewing distance. Most aisles will range from 10 to 30 feet in width and letter sizes should be in the range of visibility, 1 1/2" letters are easily read at that distance without seeming too large. The letters under the headings will likely be read when the customer enters the booth, so they can be in the 1/2- to 3/4-inch range and be compatible.

Balance between areas of the exhibit is usually a positive feature and can be accomplished in a formal or informal manner. Formal balance consists of equal sizes and arrangements, while informal balance might have one side with horizontal and the other with vertical features.

Getting acquainted with businesses that specialize in selling exhibit materials is useful in creating your display. For a fee, there are businesses that take your ideas and create a professional exhibit for you.

IDENTIFYING FUTURE PROSPECTS

Unless yours is a booth committed wholly to sales at the show, the purpose of participating is to identify future customer prospects. How well you succeed in the effort determines the value of the show to your business. Many techniques have been used to attain this end. The most common is some sort of registration device. The favorite is the drawing for designated prizes. Names and addresses are required on the entry cards.

Other techniques include mail-in cards for additional information, personal visits at the booth, and invitations to be put on the mailing list.

FOLLOWING UP PROSPECTS

The follow-up contacts are the payoff for all the efforts up to that time. The indicated interest begins the follow-up contact on a positive note. If the prospect indicated an interest in a particular line or item at the show, send more information about the line or item. The art of selling involves favorably informing the person inquiring so a sale is completed.

Do your homework on the prospects. How will they benefit from your product? How will they use it? Will it or another of your products do the job better? In the long run, a sale to make your cash register ring without regard for what it does for the customer is a bad sale. Your interest in the customer's success with the product will not be misplaced.

ADDITIONAL READINGS

- Abrams, R. M. *The Successful Business Plan: Secrets and Strategies.* Oasis Press, 1991. pp. 29-37.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Visit a trade show or fair and observe the following:
   a. Materials used in creating booths
   b. Motion use
   c. Color use
   d. Booth layout
   e. Registration techniques
   f. Merchandising displays
   g. Busy times of day
2. Visit your library and ask the reference librarian to help you find trade show information.

Activities to Aid Decision Making

1. Visit your local Chamber of Commerce and find out what trade shows are held in the area.
2. Visit the local magazine outlet and obtain relevant trade magazines. Ask the proprietor for information about available magazines not on the shelf.
3. Contact the local fair or show headquarters and find out the costs and sizes of available booths.

Questions to Increase Your Understanding of the Text

1. What are common sources for information about trade shows and fairs?
2. Why is attending a trade show valuable before exhibiting in one?
3. What questions should you ask before deciding on a trade show or fair?
4. Why is each important?
5. What is a booth theme?
6. Why is a theme important?
7. How does motion help?
8. How should color be used?
9. What is balance?
10. What are ways of identifying future customer prospects?
11. Why is a follow-up plan needed?

Questions to Aid Decision Making

1. What trade show or fairs are held in your area?
2. What are the dates?
3. What are the costs?
4. What are the deadlines for entry?

PART IV

Financial Management

CHAPTER 12

Setting Prices*

CHAPTER GOALS

- To introduce pricing concepts.
- To identify **direct** and **indirect costs**.
- To learn how to assign costs of doing business.
- To learn how to set prices.

KEY CONCEPTS

Allocated costs – Costs of which a proportional share are assigned to given products or services. Indirect costs are allocated when pricing the product or service and thus, are referred to as allocated costs.

Cost of sales – A subheading on the income statement which identifies the direct costs of products or services sold.

Costs – The money measurement of resources used to produce a product or service.

Direct costs – Costs that can be traced directly to and are caused by the product or service.

Expenses – An accounting term for cost. A subheading on the income statement which identifies indirect costs.

Full cost – The total cost to produce a good or service which includes all direct costs and a proportionate share of indirect costs.

Gross profit – The calculated difference between sales and cost of sales.

Indirect costs – Costs that cannot be traced to a specific product or service. When pricing the product, good, or service, these costs must be allocated. Indirect costs are often referred to as overhead costs, general and administrative costs, operating expenses, and similar items on the income statement.

Labor costs – The total cost of the labor to produce a product or service. This cost includes such items as the hourly wage; fringe benefits; social security, Medicare and unemployment contributions; and insurance such as worker compensation or public liability and property damage when such insurance is tied to the payroll.

Mark-up – An amount added to the direct cost of the product or service to include an allocated share of indirect costs and profit.

Material costs – The total cost of the materials used to produce the good or service.

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* By Dr. Frederick B. Muehlhausen, Associate Professor of Technology, Purdue University

CASE STUDIES

Rinky Daly Is about to Sink

Ronald Daly finally reached his goal: to start his own construction company. Ron, known to his friends as "Rinky," had a number of years' experience in the construction trades and was well respected. With his savings, his financial statement was adequate to secure a loan from his local banker. He began contracting construction jobs. Rinky operated his business out of his home and things went well for a time. However, as Rinky's business grew, he had to borrow more money for a warehouse and office to accommodate his growing business.

As economic conditions changed, Rinky's banker noted problems with the loan due to slow payment and a request for extensions with different repayment terms. Rinky was still doing excellent work and his customers were satisfied. The loan officer had to make a tough decision, should the bank call the loan and take the loss, or continue to work with Rinky to try to locate and solve the management problems? Due to their previous experience with Rinky they decided to work with the business.

The bank officer was knowledgeable in construction lending. When the bank officer worked out a current balance sheet with the Dalys, Nancy and Ron, he discovered Rinky actually had a negative net worth!

Upon further analysis, it was discovered that Rinky's pricing policy was built upon a shaky foundation. He was very competent in managing the construction side of business, but felt inadequate on the financial aspects. As Rinky bid work, he would accurately estimate the cost to build projects such as **labor costs** and **material costs**. Rinky's pricing policy was to figure these costs and then **mark-up** these costs 20 percent for overhead and profit. This mark-up rate was a "rule of thumb" that had been floating around the industry for years. He was the successful bidder often because his bid did not reflect the full cost of the construction project; the mark-up applied was not accurate because it did not reflect Rinky's **indirect costs**. His wife, Nancy, the bookkeeper, had tried unsuccessfully to get him to understand these costs. With some coaching and persistence, an outside consultant got Rinky's bids to reflect the full cost and provide an opportunity for profit. He was a bit slower in getting the contracts but those he did get were profitable.

Pat Bakes Her First Cake for Hire!

Pat enjoyed decorating cakes and had several friends who thought she was creative in her decorating. Her cousin was having a big birthday celebration for a younger sister. She asked Pat to do the cake and offered to pay her. Pat agreed and produced an attractive cake to the pleasure of the guests. She spent several hours on the decorating job, but charged the cousin only the cost of materials used.

When others inquired about having a cake prepared, Pat talked with her father, who was a businessman, about how to set a fair price. Although she enjoyed the work, Pat didn't want to spend her time without a profitable return.

Her father saw an opportunity to teach a business lesson and suggested some of the items Pat should consider in setting prices. He suggested the following items as appropriate to the **cost** of baking and decorating cakes:

1. Cake mix or ingredients
2. Frosting materials
3. Coloring materials
4. Flavorings
5. Accessories such as the figures, layer supports, and similar items
6. Packaging materials
7. Equipment costs such as the cake decorating tools, oven, mixer, spatulas, pans, and other items used
8. A proportional share of utilities and kitchen-use costs
9. Labor costs
10. Management return
11. Profit

Notes from the Case Studies

1. Pricing is a very difficult task for entrepreneurs.
2. Many more items enter into setting prices than ingredients alone.
3. Not all costs can be traced to a specific job.
4. Indirect costs must be determined before an accurate price can be set for a product or service.
5. Price competition may lead to losses.

COSTS AS A BASIS FOR PRICES

Pricing

Probably the single most misunderstood and improperly applied business decision made by the small business owner is that of pricing the product, project, or service the company sells. Why? The wrong force sets the price – the competition!

Many new small business owners informally survey the price of similar products of existing businesses. Then, the new owner applies the same price to become competitive or sets a lower price in order to gain customers. What is wrong with this method?

The obvious answer is that the price must first satisfy all costs of doing business. Not only should the cost of materials and labor to produce the product or service be included, but the price should reflect a proportional share of the costs of operating the business.

In short, when the new business uses the competition's price to establish a pricing policy, the price assumes that the cost and profit structure of the new business is identical to that of the competition. This is not true! No two small businesses in the same market operate in the same way; thus, the cost of producing a product will differ and so should the price!

Why do new small businesses (and existing ones) establish prices based on their competition? Because it is easy to do! How should new and existing small businesses compete, if not on price? The answer is – use any competitive advantage as seen in the eyes of the customer. These include the following:

1. Customer type
2. Product quality
3. Product performance
4. Product uniqueness
5. Quality of service
6. Timeliness of delivery
7. Courtesy to customers
8. Production efficiency
9. Time utility
10. Place utility

How should new and existing small businesses price their product or service? By becoming thoroughly knowledgeable of the **full cost** of the product or service.

Full Cost

"Cost" is an elusive concept. Probably no other issue is more misunderstood by small business owners. Many owners do not fully understand that a proportional share of the business' **indirect costs** (often referred to as overhead or operating expenses on the income statement) should be assigned to each product, project, or service sold. Too often business owners cannot identify these costs and therefore, make poor decisions in pricing their work.

A generic definition of "cost" is the dollar measurement of the amount of resources used for some specific purpose. The following three ideas are contained in this definition.

1. *The use of resources is required.* This includes quantities of material, hours of labor and equipment usage, and the support of company or business operations.

2. *Cost measurement is expressed in dollar terms.* The dollar becomes a common denominator that permits the amount of individual resources (each measured according to its own scale) to be combined so that the total amount of all resources used to produce a product or services can be determined.

3. *Cost measurement is related to a specific purpose.* No cost should be incurred without some statement of the nature or reason for the cost.

Full cost is a term used to describe the dollar measurement of all resources used to accomplish an objective. It includes all direct costs caused by the product or service, and a portion of the indirect costs required to operate the business.

Direct Costs

Direct costs are those costs which are caused by and are directly traceable to the product, project, or service. If that specific product, project, or service is not produced, built, or supplied, then the cost is not incurred. For example, Beth buys flour to make the baked goods sold at the Corner Bakery. For each baked good, she knows the exact amount of flour to be used. She can trace the amount of flour to each product and thus trace the expense of the flour to each product. If she does not bake that product, then no flour is needed and no expense for flour is incurred.

Indirect Costs

Indirect costs are those expenses which are caused by two or more products, projects, or services which cannot be traced to any individual product, project, or service. In short, even if that individual product is not produced, the expense is still incurred. For example, Beth pays rent each month for the space occupied by the Corner Bakery. Without the space, she could not bake her products; therefore, the rent expense is an indirect cost of each baked good. A share of this cost must be allocated to each bakery product. (An indirect cost is commonly referred to as an **allocated cost** when pricing a product or service.) If Beth decides not to make any pies today, no pie ingredient is incurred (a direct cost), but the rent must still be paid (an indirect or allocated cost).

Identifying Direct and Indirect (Allocated) Costs

The income statement for the Corner Bakery, Figure 12-1, summarizes the costs ("expenses" in accounting terms) for the year ending December 31, 1991. Note that this represents the first six months of operation as detailed in another chapter.

Stacey evaluates each cost and decides whether it is a direct cost or an indirect cost as follows (we used Stacey's records for this section):

The costs that she can trace directly to a product are *direct costs*. In this case her direct costs are food items (her raw materials).

The costs that she cannot trace to a specific product are *allocated* or *indirect costs*. These are the following:

1. Wages
2. Rent
3. Cleaning
4. Trash
5. Sales tax
6. Paper products
7. Telephone
8. Gas
9. Electricity
10. Advertising
11. Interest expense
12. FICA tax
13. Depreciation

CORNER BAKERY INCOME STATEMENT

(Period 7/1 to 12/31/91)

DESCRIPTION	
Bakery sales	$ 64,729.90
Cost of Sales	
Food (raw materials)	16,569.65
Total Direct Costs	16,569.65
GROSS PROFIT	**48,160.25**
Expenses	
Paper products	2,569.89
Wages	13,195.28
Rent	4,405.00
Cleaning	210.54
Trash	245.91
Telephone	252.00
Gas	232.62
Electricity	1,623.21
Advertising	1,834.39
Interest	299.10
Depreciation	900.00
Taxes	4,245.88
TOTAL INDIRECT COSTS	**$ 30,013.02**
NET PROFIT	**$ 18,147.23**

Figure 12-1 Corner Bakery income statement

The last item listed, depreciation, is different because the equipment is assumed to have a ten-year life, so its cost is allocated over ten years.

Note that the actual operating period recorded was for six months. Thus, only one half of the yearly depreciation was listed. Note also, that direct cost items are listed under "Cost of Sales" while indirect cost items are listed under "Expenses" on income tax Schedule C, Form 1040.

PROFIT REQUIREMENTS

Possibly the number one motive for an entrepreneur to start a new small business is to become independent. The second may be to acquire more wealth than can be made by working for someone else. In accounting

terms, in order for the owner's wealth to increase, the new small business must operate profitably. Simply stated –

PROFIT = REVENUES - COSTS

The question arises, what profit must be generated by the business in order to satisfy the owner?

There are at least three ways in which the small business owner can determine the profit goal for the year. These methods are called –

1. **Lump Sum Method**
2. **Sales Volume Method**
3. **Return on Investment Method**

Applying the **Lump Sum Method**, the owner merely determines how much profit he/she wishes the business to yield. This amount may be based on some preconceived notion, a guess, or it may reflect a careful analysis of what the personal living requirements are of the owner. In either case, the profit requirement or goal is expressed in hard dollar terms such as $50,000.

Applying the **Sales Volume Method**, the owner decides what risk is involved in operating the business. Thus, unlike the other two methods, as volume increases, profit increases based on a predetermined relationship between volume and profit. In this case, the profit requirement or goal is expressed in percentage terms such as 10 percent. Like the Lump Sum Method, the percentage rate is often no more than a preconceived notion in the mind of the entrepreneur. It is rarely a calculated rate.

Applying the **Return on Investment Method**, the owner decides what risk is involved in owning the business. The owner has wealth invested in the business. Personal cash and other assets are given to the business so it can initially produce the product or service for sale, or cash is used to buy the business if it is a going concern. In either case, the business returns to the owner the wealth commensurate to the riskiness of the investment. Thus, the profit goal can be calculated by using the following formula:

NET PROFIT = RATE (%) x NET WORTH

Let's use the Corner Bakery as an example. Suppose Stacey, the previous owner, bought the business using her own cash rather than borrowing from the bank. Thus, she bought the business for $6,000. Which method should she use to determine her profit goal?

Can Stacey use the "Sales Volume Method?" Yes – she believes that a 10 percent profit on all products is fair to the public. Suppose she estimates that her sales volume for the first year of business is $60,000. Applying the 10 percent profit goal would net Stacey $6,000 (before taxes).

Can Stacey use the "Return on Investment Method?" Yes – let's assume she believes that a 20 percent return on her invested capital ($6,000) is satisfactory. Thus –

NET PROFIT = RATE (%) x NET WORTH

NET PROFIT = 20% x $6,000.00

= $1,200

The profit goal would be $1,200.

Do you suppose Stacey is interested in running a bakery for $1,200 or even $6,000 per year? Obviously not! Therefore, Stacey should apply the "Lump Sum Method." In determining this amount, Stacey estimates her living needs. She works many hours at the bakery and, as a sole proprietor, profits generated by the business supply her personal needs. (She does not pay herself a wage, but draws cash as she needs it for personal expenses.) In Stacey's case, the business must support both her and her husband while he finishes his Master's Degree. Let's suppose that Stacey estimates her personal need before taxes to be $30,000. This is a "lump sum" which is not dependent on her investment in the store or the riskiness of her baking business. Instead, it is dependent upon her personal need to survive!

Let's look at another example – brothers Tom and Tim Kennedy want to build pole barns and other agricultural buildings. They have inherited $100,000 from their grandfather and have always wanted their own business.

Both Tom and Tim will receive a salary because they work for the business as well as own it. At the same time they are investing their labor, they are also investing their inheritance ($100,000). Thus, the brothers should be paid individually for the work they do and as investors in the business.

Unlike Stacey, the brothers' personal needs are satisfied by the salary they are paid. It compensates them for their work managing the business. But, the salary does not compensate them for their investment of $100,000 in the business. It is sensible to base the profit goal on the brothers' required return on investment.

Let's say that the brothers could have invested their $100,000 inheritance in a relatively safe way (through the bank) with a guaranteed return of 10 percent. Would the same rate generated by their contracting business satisfy them? No!

Why? Their inheritance is at much greater risk since they decided to invest it in a contracting business. Thus, the return on the investment should be higher to compensate for the risk. Tom and Tim decided that contracting to build agricultural buildings is a risky business. Instead they set a minimum return on investment of 20 percent. The calculated profit goal would be –

PROFIT = RATE (%) x NET WORTH
= 20% X $100,000
= $20,000

PRICING PROCEDURE

When the full cost of a product and the small business owner's profit goal are known, the product's price can be calculated. This price will reimburse the business for the full cost of the product, project, or service and yield the desired profit goal.

The procedure for pricing the products sold or produced, the projects built, or the services rendered for various businesses may vary. However, the following procedure represents a workable yet easy-to-accomplish method for establishing "price" based on the business' full costs to

produce the product, complete the sale, build the project, or render a service to the customer:

1. Determine the products, projects, or services to be sold by the business.
2. Determine the direct cost of goods sold, products produced, projects built, or services rendered. Direct costs are costs which are caused by and directly traceable to an individual product, project, or service. Typical direct cost items include materials, labor, equipment, contracted or subcontracted work, or any other expense in which the full amount of the cost can be traced.
3. Determine and allocate a proportional share of indirect costs to each cost objective: goods sold, products produced, projects built, or services rendered. Indirect costs are any costs which are caused by two or more products, projects, or services and cannot be traced specifically to any one of these (or at least it is not reasonable to do so).
4. Determine and allocate a proportional share of profit to each good sold, products produced, projects built, or services rendered.
5. Combine the direct costs, allocated indirect costs, and allocated profit to arrive at the price.

STACEY PRICES A CAKE

1. *Identify the product.*

   Stacey identifies one of the Corner Bakery's products – an iced, double-layer, white cake.

2. *Determine direct costs.*

   Stacey estimates the amount of direct costs required for the specific product – the iced, double-layer, white cake. For the Corner Bakery this includes raw materials, packaging, and sales tax.

   Stacey goes to her recipe file and determines the quantity of each ingredient that goes into the cake. She then calculates the cost of each ingredient and multiplies it by the quantity. This gives her the total raw material cost of the cake. After determining the cost of the cake box, Stacey figures the following direct costs of the cake:

Raw materials	$ 2.25
Cake box	$ 0.50

   The sales tax of 5 percent is added at the time of the sale. Thus, the dollar amount for sales tax cannot be computed until the price is established.

3. *Determine and allocate indirect costs.*

   After the direct costs for a product are estimated, the indirect costs are "allocated" to each product. Generally, some basis for allocation is used which has a direct relationship to the product itself. In this instance, the only item which has a direct relationship to the product is the material cost. Thus, Stacey allocates indirect cost items to bakery goods (and thus the iced, double-layer, white cake), based upon the amount of material cost in each bakery item.

The question arises, at what rate should indirect costs be allocated to material costs for the bakery item?

The Corner Bakery Profit and Loss Statement for the year (not shown) indicates that, for the first year of operations, the relationship of indirect costs to material cost is –

$$\text{Percentage Relationship} = \frac{\text{Indirect Cost}}{\text{Raw Material Cost}} \times 100\%$$

$$= \frac{\$\ 33{,}000}{\$\ 18{,}000} \times 100\%$$

$$= 183\%$$

Based on this experience, whenever Stacey prices a baked good she will increase the cost of the raw materials by 183 percent or 1.83 times in order to be reimbursed for a proportional share of the indirect costs. (At this point the reader may think this mark-up rate is too high! Do not let preconceived notions of what is right, wrong or fair mislead you into giving your product away!)

4. *Determine and allocate profit.*

The rate at which profit is allocated to the bakery item is calculated in the same fashion as indirect costs. If Stacey were satisfied by the estimated year's profit of $3,800, then her calculations would be as follows:

$$\text{Percentage Relationship} = \frac{\text{Profit Goal}}{\text{Raw Material Cost}} \times 100\%$$

$$= \frac{\$\ 3{,}800}{\$\ 18{,}000} \times 100\%$$

$$= 21\%$$

However, Stacey's profit goal is $30,000. Thus, the **mark-up** rate for profit should be calculated as follows:

$$\text{Percentage Relationship} = \frac{\text{Profit Goal}}{\text{Raw Material Cost}} \times 100\%$$

$$= \frac{\$\ 30{,}000}{\$\ 18{,}000} \times 100\%$$

$$= 167\%$$

Thus, whenever Stacey prices a baked good she will increase the cost of raw materials by 167 percent or 1.67 times for profit.

Stacey can now price the iced, double-layer, white cake as follows:

Raw materials	$ 2.25
Cake box	0.50
Indirect costs (1.83 x $2.25)	4.12
Profit (1.67 x $2.25)	3.76
Total Price	**$ 10.63**
Sales tax (0.05 x $10.63)	0.54
Total with tax	**$ 11.17**

By applying her knowledge of full costs and profit requirements, Stacey can easily determine the price required for each item the bakery produces. More than likely, she will round-off the price for individual baked goods to make computations easier during the day-to-day sales. For example – the iced, double-layer, white cake could be priced at $11.00 plus sales tax.

COMPETITION IN PRICING

Only after the pricing is completed (based on the full cost of the product and the profit goal established by Stacey), does she view her competitor's price for similar products. If she is competitive (not necessarily the cheapest) she continues to apply "mark-up" rates as calculated.

If she is not price competitive the question arises, can she sell her product at a higher price than the competition? It happens every day! Reexamine the list earlier in the chapter. Possibly, Stacey could decorate her shop to offer a quaint atmosphere to entice people to patronize her business.

If Stacey cannot trade on anything but price (which is rarely the case for entrepreneurs), and expects little or no sales at the price calculated, then she must do one or more of the following:

1. *Get out of that product line.* Stacey should produce only those baked goods which are competitive. For example, Stacey's shop cannot produce donuts as cost effectively or as quickly as the donut chain store across the street. However, the chain store does not offer coffee cakes. Thus, Stacey does not offer donuts, but advertises a tasty breakfast alternative to donuts – specialty coffee cake.

2. *Lower her direct costs of production.* If Stacey can lower the cost of producing the bakery items, then she can lower her price (become more price competitive) and still reach the profit goal. She can lower her costs by buying raw materials at a lower price or she can lower the individual cost by producing more with the same resources of labor, space, and similar items.

3. *Lower her operating costs.* If Stacey can lower the cost of being in business – i.e., rent, utilities, insurance, advertising, and similar items, then she can lower her price and still yield the desired profit.

After Stacey makes one or more of the operating changes above, she reestimates her year end profit statement. She then uses this statement to recompute her "mark-up" for indirect costs and profit.

If Stacey's price for the product is much lower than the competition's price for the same or similar product, then she should consider increasing the price of the product even though she will return the desired profit at the lower price. In this instance, Stacey should charge what the market will bear, which is greater than the full cost plus profit for the product.

ADDITIONAL READINGS

1. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 217-230.

2. Meyer, W. G. *Retail Marketing.* Gregg Division McGraw-Hill Book Company, 1993. pp. 445-451.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Complete the following chart to increase your understanding of costs. Use the profit and loss statement figures from Figure 12-1.

Item	DOLLAR AMOUNTS Indirect (*or Allocated*)	Direct
Food	_____	_____
Paper products	_____	_____
Sales tax	_____	_____
Wages	_____	_____
Rent	_____	_____
Cleaning	_____	_____
Trash	_____	_____
Telephone	_____	_____
Gas	_____	_____
Electricity	_____	_____
Advertising	_____	_____
Interest	_____	_____
FICA	_____	_____
Depreciation	_____	_____
TOTALS	_____	_____

2. Conduct a similar analysis for your planned business.

Activities to Aid Decision Making

1. Interview one or more entrepreneurs to find out how their prices are set.

2. Search the library to determine common mark-ups for a particular industry.

Questions to Improve Your Understanding of the Text

1. Why does competition ultimately drive prices?

2. What are direct costs?

3. What are indirect or allocated costs?

4. What is a proper way to allocate indirect costs?

5. What is the lump sum method of setting profit goals?

6. When does one look at the competition's prices?

Questions to Aid Decision Making

1. How does my cost compare to others?

2. What is my competitive advantage?

3. How will it affect price?

CHAPTER 13

Keeping Score

CHAPTER GOALS

- To introduce basic record-keeping concepts.
- To identify the single-entry accounting system.
- To identify the double-entry accounting system.
- To identify the period report.

KEY CONCEPTS

Accounting – Recording, classifying, analyzing, interpreting, summarizing, and reporting financial transactions.

Asset accounts – Accounts which record transactions of "things" (such as cash, land, receivables, buildings, and similar items) owned by the business.

Bookkeeping – Systematically classifying and recording business financial transactions and events.

Business entity – The business as it exists separate from its owners.

Chart of accounts – A list of asset, liability, net worth, revenue, and expense accounts maintained in the company's books.

Contract – The type of sale agreement in which the asset ownership does not change until payments are completed.

Cost of goods sold – The total of direct costs.

Credit – Entry in the right-hand column that increases a liability, net worth, or revenue account or decreases an asset or expense account.

Debit – Entry in the left-hand column that increases an asset or expense account or decreases a liability, net worth, or revenue account.

Double-entry – A method of recording the debits and credits of a business transaction or financial event in a **journal** and a **ledger**. The sum of all debits numerically equals the sum of all credits.

Entity – Something that exists independently.

Event – Accounting entry to recognize a value change between two or more accounts within the business.

Income statement – A report summarizing the revenue and expense transactions for a period between two balance sheet reports. (Sometimes called a profit and loss statement or a P & L.)

Individual entity – You or I as an individual.

Journal – The book of original entry used to record, usually in chronological order, each business and/or financial **transaction** and **event** of the business.

Ledger – The book used to record or "post" each transaction and event recorded in the journal to individual accounts as a credit or debit.

Liability accounts – Accounts in which amounts owed by the business are recorded (such as payables, loans, and similar items).

Net worth – Owner's equity or the value of assets in excess of the liabilities of the business.

Non-business entity – An organization such as a church, school, or other nonprofit organization.

Paid-in capital – The money invested in the business by its owners or shareholders.

Period report – Summary of income and expense for a given time period, such as an income tax schedule. Sometimes it is called an **income statement** or **profit and loss** statement.

Posting – Recording each transaction from the journal to the ledger.

Profit and loss statement – A report summarizing the revenue and expense transactions for a period between two balance sheet reports.

Promissory note – A signed, written promise to pay a given amount in a given time.

Retained earnings – An account that reflects the accumulated profit or loss of a company since its beginning.

Single-entry – A bookkeeping system that does not record transactions explicitly with debits equal to credits (sometimes called "one-sided entries").

Source document – A paper form such as a check, sales slip, or a receipt which supports every accounting transaction.

Transaction – Financial exchange between **entities**.

Trial balance – A listing of all accounts in the chart of accounts, along with the balance of each account, at the end of the normal accounting period.

CASE STUDY

Stacey Buys the Corner Bakery

Stacey graduated from Institutional Management while her husband was still in college. While looking for an opportunity she read an advertisement for the sale of the Corner Bakery. The price was $6,000 for the assets of the bakery (mainly equipment). The inventory of food valued at $541.85 was paid separately. Stacey did not have the necessary money to buy the business, but one of her professors was interested enough in Stacey's abilities to write her a check for $7,000.

With that seed money she was able to obtain two loans, one from the bank and one from a friend. Thus, she started a success story we will use to cover the basics of simple business **accounting**. We have actual sales revenues and expense figures from the business and permission to use the financial records to help you understand business records.

On June 1 Stacey started with essentially no monetary assets. Using two auto titles as security, the bank loaned her $5,000. She repaid the professor $5,000 and gave him a $2,000 **promissory note** for the remainder of the loan. Another friend loaned her $1,500.

The owners agreed to sell. They took a $3,000 down payment and agreed to accept the remaining $3,000 in monthly payments of $139.82 per month for two years. On July 1 Stacey was in business for herself! The Corner Bakery Journal appearing later in this chapter details the business records.

Stacey focused on a lunchtime trade and used a show case to sell made-from-scratch products with qualities not found in a grocery store or other bakeries. No preservatives were used and all products were dated. Recipes were very carefully selected, tried, and finally tested with her own modifications. To increase income she added a catering service and the business grew. As you work through the journal you will see the growth.

Notes from the Case Study

1. Unsecured loans are difficult to obtain.
2. A contract purchase may help financing.
3. Adequate operating capital is essential to success.
4. A business focus is needed.
5. Quality is important.
6. Businesses may be expanded by many different ways.
7. Businesses must keep records adequate for tax reporting.
8. Businesses frequently get their financing from relatives or friends.
9. Stacey needed to establish an IRS-approved accounting system.

BOOKKEEPING AND ACCOUNTING

Bookkeeping is the keeping of systematic records of business transactions and events; accounting is the principles or practice of systematically recording, presenting, and interpreting financial accounts. We could greatly oversimplify and say accounting is more advanced than bookkeeping.

We are all bookkeepers from the standpoint that we report our income taxes based on record keeping of some type. Business records are necessary for tax purposes, but are far more valuable for other reasons to the entrepreneur. The entrepreneur should keep records on the following items in order to know the score:

1. Total sales
2. Inventory on hand
3. Materials to purchase
4. Accounts receivable which are due
5. Accounts payable which are due

6. Assets purchased (for example equipment)
7. Wages and salaries paid
8. Taxes paid (sales tax, property tax, payroll taxes, income taxes)
9. Cost of goods sold

A business owner or manager loves a record system that helps in the decision-making process.

What Accounting Is and Is Not

We all arrived in this world with no material resources; we had a potential to learn – our mind skills – and a potential to develop our muscle skills. Our money and other material resources came from gifts, or in exchange for the use of our mind or muscle skills.

Learning, earning, consuming, and investing are words we could use to describe living processes in business terms. Until we began using our mind and muscle skills to earn, we were consuming the resources of others. As we earn more than we consume we use our extra money to become investors in our business or others' businesses. As entrepreneurs we will continue the process throughout our lives.

Accounting is not management, but it is important to management decision making. The bookkeeping or accounting rules demonstrated in this chapter will help you collect the information you need for your decision making.

Accounting might be called a set of rules for collecting and reporting financial information about a business. It is a helping activity. Everyone in a business can be involved in recording the information needed in the accounting or bookkeeping system used by the business.

The Simplest System

The **single-entry** system has been called the simplest bookkeeping system. This is because the entries are made only in the checkbook, or the checkbook and a journal. This limited record is adequate to provide tax return documentation. The IRS has informational aids for such a system. To use the information you will have to group together several entries. For example, your income tax form shows you what like kinds of entries are grouped before completing the form. Monies paid for supplies are grouped together. The term "account" refers to such a grouping of like entries.

Office supply companies and stationery stores often stock forms for single-entry systems. The records start with a **source document** (sales ticket) to record the needed information. For a cash sale write the date, description of the item sold, quantity, unit price, amount, name of clerk or salesperson, tax (if any), and total received.

In a credit sale, the amount of information on the sales slip includes these additional items: customer's name, address, and telephone number; terms of the sale; and customer's signature.

The single-entry system needs to provide the following features:

1. An up-to-date cash position
2. Accuracy in tax reporting
3. Accuracy of accounts receivable
4. Accuracy of payments for **accounts payable**
5. Help in future projections

The Double-Entry System

The **double-entry** system gets its name from the recording of the debit and credit entries for every transaction or **event** into the journal and the ledger. In a ledger, a separate account is kept for each asset, each liability, and the **net worth** of the business. The professor's loan became the new business' first asset. In accounting, to record an increase in an asset you **debit** the asset's account. (Note the first entry in Stacey's journal.) In this case, to complete the recording of the transaction an account – in this case a liability account called "loans" – needs to be credited for the same amount. You **credit** a liability account to show an increase in amount.

The basic accounting equation is –

ASSETS = LIABILITIES + NET WORTH (OR OWNERS' EQUITY)

By accepting the loan and recording this transaction in the journal, assets increased, but liabilities increased by an equal amount and the net worth remained unchanged.

The **chart of accounts** for a business lists the ledger accounts used by that business. Figure 13-1 shows a chart of accounts for the Corner Bakery.

CORNER BAKERY CHART OF ACCOUNTS

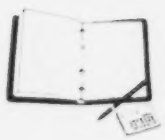
	Account Numbers
Asset Accounts	
Checking	101
Inventory	102
Equipment	103
Utility deposits	104
Liability Accounts	
Loans	201
Accounts payable	202
Payroll taxes payable	203
Net Worth Accounts	
Paid-in capital	301
Retained earnings	302
Revenue Accounts	
Sales	401
Expense Accounts	
Cost of goods sold	501
Advertising	502
Depreciation	503
Interest	504
Rent	505
Services	506
Supplies	507
Taxes	508
Utility expense	509
Wages	510

Figure 13-1 Corner Bakery chart of accounts

In a more complete chart of accounts some of these accounts are subdivided. For example, if information on different kinds of baked goods sold is desired, the sales account is subdivided into cakes, cookies, and like items. The utilities and services accounts are separated into each category of expense as well.

Accountants decide how many account categories to set up for a business. Bookkeepers record transactions and events in the business' journal.

A transaction is a financial exchange of goods or money between entities. An event is an accounting entry within the business. The depreciation entry on 12/31 is an event. The purchased equipment is depreciated for the six months. Since depreciation is a business deduction it is recorded in the company's books. **Entities** describe an independent existence. For example, you and I are **individual entities**. A church or school is a **nonbusineess entity.** A corporation, partnership, or sole proprietor is a **business entity**.



The journal is called the book of original entry with transactions recorded in the order in which they occurred. The Corner Bakery journal (Figure 13-3) is an illustration. In the journal you find the financial history of the business. Each line of the journal has a space for the date, a space to enter a brief description of the transaction and two columns for entering the financial amounts of the transaction. The left column is for the debit amount and the right for the credit amount. Each transaction or event entry in the journal has equal totals of debits and credits.

The basic accounting rule is observed: debits equal credits. A line is used in the journal for each account debited or credited. Accurate entries are important because later reports based on these entries depend upon accuracy.

In a double-entry system, each account has a column for debit entries and a column for credit entries. The debit entry(ies) must equal the credit entry(ies) in other accounts. The double-entry system provides the paper trail needed to document and verify account balances. When reports are prepared the entries are totaled and the differences – the balances – are placed in the reports.

Note again the first entry in the Corner Bakery Journal. In the double-entry accounting system it became an increase to an asset account by being debited to the checking account and an increase to a **liability account** called "loans" with a credit entry.

If the professor and the friend had made the loans to Stacey as an individual, the loans would not have appeared on the Corner Bakery records. Because we have chosen not to present Stacey's personal financial information, we have decided to treat the loans as if they were business loans to the Corner Bakery.

Stacey's Corner Bakery Balance Sheet on June 30, the day before she bought the bakery, would have looked like Figure 13-2.

Stacey's Corner Bakery Balance Sheet – 6/30/90

Assets	
Checking	$ 7,000.00
Liabilities	
Loans	$ 7,000.00
Net worth	
Paid-in capital	$ 0.00

Figure 13-2 Corner Bakery balance sheet as of 6/30/90

When Stacey sold the bakery, the last entry in the journal would have been a payment to Stacey representing the net worth of the business. The paid-in capital and retained earnings accounts would have been debited and the checking account credited.

Figure 13-3 presents a partial version of Stacey's Corner Bakery Journal for the first months of operation. We have grouped all expenses of an account for the month into one entry. Transactions for the months are presented for each account.

To illustrate how the accounts from the chart of accounts are **posted** to the ledger, Figures 13-4 to 13-17 provide a start for the Corner Bakery accounts. The balance sheet on any given date reflects the totals of asset, liability, and net worth accounts with a balance. Accounts with no balance do not appear on a balance sheet.

A balance sheet could be prepared after each event or transaction is posted; however, this procedure is seldom done. Instead, temporary revenue and expense accounts are created to provide a place to accumulate revenues and expenses until a balance sheet report is needed. This could be at the end of each business year, thus the beginning of the next year.

COMPUTING COST OF GOODS SOLD

At the end of the year (12/31/90) Stacey had to take a physical inventory to determine the food she had on hand to compute the true cost of goods sold for the year.

Part III of Form 1040 Schedule C (Appendix D) is used to determine this cost of goods sold.

Stacey found that at the year's end she had food inventory valued at $1,026.51. She used Part III of Schedule C to determine the cost of goods sold as follows:

Inventory at the beginning of the year	$ 541.85
Plus purchases	+ 9,685.97
Goods available for sale	**10,227.82**
Less inventory at the end of the year	– 1,026.51
Equals cost of goods sold	**$ 9,201.31**

This means that Stacey must make a journal entry to adjust the inventory to the year-end value of $1,026.51.

(Text continued on page 133)

Stacey's Corner Bakery Journal – 7/1/90 - 12/31/90

Date	Transaction Description	Check No.	Account	Debit	Credit
6/10	Deposit			$ 7,000.00	
			Loans		$ 7,000.00
7/1	Purchase of business assets	101	Checking		3,000.00
			Equipment	3,000.00	
7/1	Contract for balance of purchase		Loans		3,000.00
			Equipment	3,000.00	
7/1	Utility deposit - gas	102	Checking		300.00
			Utility deposit	300.00	
7/1	Utility deposit - electricity	103	Checking		750.00
			Utility deposit	750.00	
7/1	Utility deposit - telephone	104	Checking		250.00
			Utility deposit	250.00	
7/1	Deposit - personal loan		Checking	1,500.00	
			Loans		1,500.00
7/1	Deposit - bank loan		Checking	5,000.00	
			Loans		5,000.00
7/2	Food inventory	105	Checking		541.85
			Inventory	541.85	
7/2	Partial payment to professor	106	Checking		5,000.00
			Loans	5,000.00	
7/31	Deposit - July sales		Checking	3,154.71	
			Sales		3,154.71
7/31	July trash	107	Checking		38.25
			Services	38.25	
7/31	Cleaning	108	Checking		18.55
			Services	18.55	
7/31	Paper products	109	Checking		171.03
			Supplies	171.03	
7/31	Food purchases	110	Checking		1,458.15
			Cost of goods sold - food	1,458.15	
7/31	Telephone	111	Checking		42.00
			Utility expenses	42.00	
7/31	Gas	112	Checking		37.00
			Utility expenses	37.00	
7/31	Electricity	113	Checking		378.15
			Utility expenses	378.15	
7/31	Rent	114	Checking		730.00
			Rent	730.00	
7/31	Wages	115	Checking		602.02
			Wages	700.00	
			Payroll taxes payable		97.98
7/31	Contract payment	116	Checking		139.82
			Loans	125.00	
			Interest	14.82	
7/31	Check charge (bank deduction)		Checking		27.95
			Supplies	27.95	
8/31	Food purchased	117	Checking		1,641.13
			Cost of goods sold - food	1,641.13	
8/31	Deposit - August Sales		Checking	4,269.64	
			Sales		4,269.64

Figure 13-3 Stacey's Corner Bakery journal – 7/1/90 - 12/31/90 *(continued on next page)*

Stacey's Corner Bakery Journal – 7/1/90 - 12/31/90 *(continued)*

Date	Transaction Description	Check No.	Account	Debit	Credit
8/31	Rent	118	Checking		730.00
			Rent	730.00	
8/31	Wages	119	Checking		976.78
			Wages	1,500.00	
			Payroll taxes payable		523.22
8/31	Paper products	120	Checking		102.57
			Supplies	102.57	
8/31	Cleaning	121	Checking		39.86
			Services	39.86	
8/31	Trash	122	Checking		32.79
			Services	32.79	
8/31	Telephone	123	Checking		42.00
			Utility expenses	42.00	
8/31	Gas	124	Checking		37.00
			Utility expenses	37.00	
8/31	Electricity	125	Checking		278.15
			Utility expenses	278.15	
8/31	Advertising		Accounts payable		476.94
			Advertising	476.94	
8/31	Contract payment	126	Checking		139.82
			Loans	125.00	
			Interest	14.82	
September–December sales			Checking	25,171.98	
	Deposit		Sales		25,171.98
	Wages	127	Checking		5,018.54
			Wages	6,000.00	
			Payroll taxes payable		981.46
	Rent	128	Checking		2,945.00
			Rent	2,945.00	
	Food purchases	129	Checking		4,001.70
			Accounts payable	4,001.70	
	Paper products	130	Checking		924.42
			Supplies	924.42	
	Cleaning	131	Checking		152.13
			Services	152.13	
	Trash	132	Checking		174.87
			Services	174.87	
	Telephone	133	Checking		168.80
			Utility expenses	168.80	
	Gas	134	Checking		156.62
			Utility expenses	156.62	
	Electricity	135	Checking		966.91
			Utility expenses	966.91	
	Advertising	136	Checking		1,357.49
			Advertising	1,357.49	
	Advertising invoice paid	137	Checking		476.94
			Accounts payable	476.94	
	Sales taxes	138	Checking		1,628.82
			Taxes	1,628.82	
	FICA and Payroll Taxes withheld	139	Checking		2,107.50
			Taxes	504.84	
			Payroll taxes payable	1,602.66	

Figure 13-3 Stacey's Corner Bakery journal – 7/1/90 - 12/31/90 *(continued on next page)*

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Stacey's Corner Bakery Journal – 7/1/90 - 12/31/90 *(continued)*

Date	Transaction Description	Check No.	Account	Debit	Credit
	Contract payments	140	Checking		699.10
			Loans	600.00	
			Interest	99.10	
	Bank loan payments	141	Checking		1,064.50
			Loans	1,000.00	
			Interest	64.50	
	Professor's loan payment	142	Checking		1,150.00
			Loans	1,000.00	
			Interest	150.00	
	Friend's loan	143	Checking		1,575.00
			Loans	1,500.00	
			Interest	75.00	
	Equipment purchases	144	Checking		3,000.00
			Equipment	3,000.00	
	Depreciation		Depreciation	600.00	
			Equipment		600.00
	Inventory adjustment entry		Inventory	484.66	
			Cost of goods sold - food		484.66

Figure 13-3 Stacey's Corner Bakery journal – 7/1/90 - 12/31/90 *(continued)*

ASSET ACCOUNTS

Corner Bakery Checking Account

Date	Item	Check No.	Debit	Credit	Balance
6/10	Professor's loan deposit		$ 7,000.00		$ 7,000.00
7/1	Purchase of bakery	check 101		$ 3,000.00	4,000.00
7/1	Utility deposit - gas	check 102		300.00	3,700.00
7/1	Utility deposit - electricity	check 103		750.00	2,950.00
7/1	Utility deposit - phone	check 104		250.00	2,700.00
7/1	Loan from friend -deposit		1,500.00		4,200.00
7/1	Bank loan - deposit		5,000.00		9,200.00
7/2	Food inventory	check 105		541.85	8,658.15
7/2	Loan payment - professor	check 106		5,000.00	3,658.15
7/31	July sales - deposit		3,154.71		6,812.86
7/31	Trash	check 107		38.25	6,774.61
7/31	Cleaning	check 108		18.55	6,756.06
7/31	Paper products	check 109		171.03	6,585.03
7/31	Food purchases	check 110		1,458.15	5,126.88

Figure 13-4 Entries in the Corner Bakery checking account

Corner Bakery Equipment Account

Date	Item	Check No.	Debit	Credit	Balance
7/1	Purchase of bakery	Check 101	$3,000.00		$3,000.00
7/1	Contract for purchase		3,000.00		6,000.00
Sept.	Equipment purchase	check 144	3,000.00		9,000.00
12/31	Depreciation			600.00	8,400.00

Figure 13-5 Entries in the Corner Bakery equipment account

Corner Bakery Utility Deposit Account

Date	Item	Check No.	Debit	Credit	Balance
7/1	Gas deposit	check 102	$ 300.00	$ 300.00	
7/1	Electricity deposit	check 103	750.00	1,050.00	
7/1	Telephone deposit	check 104	250.00	1,300.00	

Figure 13-6 Entries in the Corner Bakery utility deposit account

LIABILITY ACCOUNTS

Corner Bakery Loans Account

Date	Item	Check No.	Debit	Credit	Balance
6/10	Professor's loan			$ 7,000.00	$ 7,000.00
7/1	Friend's loan			1,500.00	8,500.00
7/1	Bank loan			5,000.00	13,500.00
7/1	Contract loan			3,000.00	16,500.00
7/2	Partial payment to prof.	check 106	5,000.00		11,500.00
7/31	Contract payment	check 116	125.00		11,375.00

Figure 13-7 Entries in the Corner Bakery loans account

Corner Bakery Accounts Payable Account

Date	Item	Check No.	Debit	Credit	Balance
8/31	Advertising			$ 476.94	$ 476.94
9/5	Advertising	check 137	476.94		0.00

Figure 13-8 Entries in the Corner Bakery accounts payable account

REVENUE ACCOUNT

Corner Bakery Sales Account

Date	Item	Debit	Credit	Balance
7/31	July sales		$ 3,154.76	$ 3,154.76
8/31	August sales		4,269.64	7,424.40

Figure 13-9 Entries in the Corner Bakery sales account

EXPENSE ACCOUNTS

Corner Bakery Advertising Account

Date	Item	Check No.	Debit	Credit	Balance
8/31	Anytown News	Accounts payable	$ 476.94		$ 476.94
Sept.-Dec.	Anytown News	check 136	1,357.49		1,834.43

Figure 13-10 Entries in the Corner Bakery advertising account

Corner Bakery Depreciation Account

Date	Item	Debit	Credit	Balance
12/31	Equipment depreciation	$ 600.00		$ 600.00

Figure 13-11 Entry in the Corner Bakery depreciation account

Corner Bakery Interest Account

Date	Item	Check No.	Debit	Credit	Balance
7/31	Contract payment	check 116	$ 14.82		$ 14.82
8/31	Contract payment	check 126	14.82		29.64

Figure 13-12 Entries in the Corner Bakery interest account

Corner Bakery Rent Account

Date	Item	Check No.	Debit	Credit	Balance
7/31	Rent	check 114	$ 730.00		$ 730.00
8/31	Rent	check 118	730.00		1,460.00

Figure 13-13 Entries in the Corner Bakery rent account

Corner Bakery Services Account

Date	Item	Check No.	Debit	Credit	Balance
7/31	Trash	check 107	$ 38.25		$ 38.25
7/31	Cleaning	check 108	18.55		56.80
8/31	Cleaning	check 121	39.86		96.66
8/31	Trash	check 122	32.79		129.45

Figure 13-14 Entries in the Corner Bakery services account

Corner Bakery Taxes Account

Date	Item	Check No.	Debit	Credit	Balance
July-Dec.	Sales taxes	check 138	$ 1,628.32		$ 1,628.32
July-Dec.	FICA taxes	check 139	504.84		2,133.17

Figure 13-15 Entries in the Corner Bakery taxes account

Corner Bakery Utility Expense Account

Date	Item	Check No.	Debit	Credit	Balance
7/31	Telephone	check 111	$ 42.00		$ 42.00
7/31	Gas	check 112	37.00		79.00
7/31	Electricity	check 113	378.15		457.15
8/31	Telephone	check 123	42.00		499.15

Figure 13-16 Entries in the Corner Bakery utility expense account

Corner Bakery Wages Account

Date	Item	Check No.	Debit	Credit	Balance
7/31	Wages	check 115	$ 602.02		$ 602.02
8/31	Wages	check 119	976.78		1,578.80

Figure 13-17 Entries in the Corner Bakery wages account

(Text continued from page 127)

At the end of the period, the sum of the expense accounts is subtracted from the sum of the revenue accounts to determine the earnings for the period. These earnings, less any owner's withdrawals, are added to the **retained earnings** account of the net worth.

Remember – the account balances in the revenue accounts and the expense accounts are transferred to the retained earnings account. For example, if a balance sheet were made after an August

Profit and Loss Statement, the retained earnings account in the net worth would show a negative balance of ($1,007.51). This reflects that Stacey had a business loss for the period 7/1 to 8/31.

You can identify the individual entries by the amounts. Each will appear *twice* – as a *debit* to a given account and as a *credit* to the checking or another account.

TRIAL BALANCE

Before preparing financial statements, accountants prepare what is known as a "trial balance." A trial balance is simply a listing of all accounts in the chart of accounts, along with the balance of each account at the end of the normal accounting period.

The year-end trial balance (12/31/90) for the Corner Bakery appears in Figure 13-18. Using this trial balance, the financial statements, income statement, and balance sheet can be prepared. The income statement appears in Figure 13-19.

Also, a balance sheet is shown in Figure 13-20. Note that the retained earnings amount must be the beginning retained earnings value (in this case, zero) plus the current net income or loss in order for the balance sheet to balance.

Corner Bakery Trial Balance – 12/31/90

Item	Debit	Credit
Checking	$ 1,023.12	
Inventory	1,026.51	
Equipment	8,400.00	
Utility deposits	1,300.00	
Loans		$ 7,150.00
Accounts payable	2,584.97	
Payroll taxes payable	0.00	
Paid-in capital	0.00	
Retained earnings	0.00	
Sales		32,596.33
Cost of sales - food	9,201.31	
Advertising	1,834.43	
Depreciation	600.00	
Interest expense	418.24	
Rent	4,405.00	
Services	456.45	
Supplies	1,225.97	
Taxes	2,133.66	
Utility expense	2,106.63	
Wages	8,200.00	
TOTALS	**$ 42,331.32**	**$ 42,331.32**

Figure 13-18 The Corner Bakery trial balance as of 12/31/90

Stacey's Corner Bakery Income Statement

7/1/90 - 12/31/90

Sales	$ 32,594.29
Cost of sales	9,201.31
GROSS MARGIN	**$ 23,395.02**
Operating Expenses	
Advertising	$ 1,834.43
Depreciation	600.00
Interest expense	418.24
Rent	4,405.00
Services	456.45
Supplies	1,225.97
Taxes	2,133.66
Utility expense	2,106.63
Wages	8,200.00
TOTAL OPERATING EXPENSES	**$ 21,380.38**
NET INCOME	**$ 2,014.64**

Figure 13-19 Corner Bakery income statement – 7/1/90-12/31/90

The Corner Bakery Balance Sheet – 12/31/90

Assets	
Cash	$ 1,023.12
Inventory	1,026.51
Total current assets	2,049.63
Equipment, net of depreciation	8,400.00
Deposits	1,300.00
TOTAL ASSETS	**$ 11,749.63**
Liabilities and Equity	
Notes payable (loans)	$ 7,150.00
Accounts payable	2,584.99
TOTAL LIABILITIES	**$ 9,734.99**
OWNER'S EQUITY (Retained Earnings)	**2,014.64**
	$ 11,749.63

Figure 13-20 The Corner Bakery balance sheet as of 12/31/90

Since Stacey and her husband had been filing income taxes by the calendar year, they needed these reports to complete their tax Forms 1040 and Schedule C.

Schedule C, Form 1040 (Appendix D) can be completed from the income statement.

Lines A through F are completed with the identification information required.

Line 1, Gross receipts, is the total income – $32,594.

Line 2, Returns, is blank so line 3 is the same as line 1.

NEXT WE DO PART III.

Line 33, Inventory, is the original inventory purchase 7/1 – $542.

Line 34, Purchases, is the supplies purchased – $9,686.

Lines 35, 36, and 37 are blank.

Line 38 – $10,228

Line 39 – $1,027

Line 40, Cost of goods – $9,201, is transferred to Line 4.

Line 5, Gross profit – $23,395

Line 6, blank

Line 7, Gross income – $23,395

PART II

Line 8, Advertising – $1,834 (Omitted lines are blank.)

Line 13, Depreciation – $600

Line 16b, Interest – $418

Line 20b, Rent – $4,405

Line 22, Supplies – $1,226

Line 23, Taxes – $2,134

Line 25, Utilities – $2,107

Line 26, Wages – $8,200

Line 27b, Services – $456

Line 28 – $21,380

Line 29, Tentative profit – $2,015

Line 31 – $2,015 (**Note:** the difference between this number and the income statement is due to the rounding of numbers on the tax form.)

Line 32a, checked

Line 31, transferred to Stacey's Form 1040.

ADDITIONAL READINGS

1. Anders, R. L., and Dunkleberg, J.S. *Managing Small Businesses.* West, 1993. pp. 391-402.
2. Antoniotti, Walter. *Financial Accounting.* 21st Century Learning Products, 1991. pp. 1-14.
3. Ely, V. K. *Entrepreneurship.* Glencoe/McGraw-Hill Education Division, 1990. pp. 140-158.
4. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 117-154.
5. Kamoroff, B. *Small Time Operator* Bell Springs Publishing, 1991. pp. 37-44.
6. Swanson, Ross, and Hanson. *Century 21 Accounting,* 5th Edition. South-Western, 1992. pp. 1-16.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Using the information in Figure 13-21, complete the Corner Bakery income statement for the period.
2. Using the information in Figure 13-21, complete a trial balance and a balance sheet for the end of the period.
3. Using an analysis sheet 3-column pad, complete the entries for each of the Corner Bakery accounts for the period.
4. Create a chart of accounts for your family and post the transactions for a month.
5. What is your net worth today? Use your chart of accounts as you record your inventory of assets and debts. Then calculate the difference which is your net worth.

Activities to Aid Decision Making

1. Visit an office supply store and examine their packaged bookkeeping systems.
2. Visit a computer software dealer and have them demonstrate their accounting software.

Questions to Increase Your Understanding of the Text

1. What is the difference between bookkeeping and accounting?
2. What is a balance sheet?
3. What is a profit and loss statement or period report?
4. What is a transaction?
5. What is an entity?
6. What is a chart of accounts?
7. What information is reported on IRS Form 1040, Schedule C?
8. What is a single-entry record system?
9. What is the double-entry accounting system?
10. A debit is the term applied to which column – right or left?
11. A credit always appears in which column – right or left?

Questions to Aid Decision Making

1. Which accounting system is more appropriate to my enterprise?
2. Which computer program offers my enterprise the most of what I need for the money?

The Corner Bakery Transactions, First Quarter of the Year, 1991

To confirm opening balances: Checking – $1,023.12; Inventory – 1,026.51; and Equipment (net of Depreciation) – 8,400. All payments were made by check.

1. January sales (including sales taxes) deposited in the checking account 1/31/91 totaled $8,035.71.
2. Gross wages paid to employees in January totaled $1,900.00. Payroll taxes withheld (FICA, federal income taxes, state taxes, and local income taxes) totaled $464.70. Employees' net pay paid by check 1/31/91 totaled $1,435.30.
3. January payroll taxes withheld paid by check at the end of January were $464.70, along with the employer's $109.50 FICA owed.
4. Sales taxes collected in January and paid by check at the end of the month totaled $382.65.
5. January rent paid by check 1/31/91 was $755.00.
6. Food purchased on account 1/31/91 was $1,843.20.
7. Accounts payable paid by check in January was $2,584.99.
8. Paper products purchased 1/31/91 were $80.78.
9. Cleaning services bill paid by check 1/31/91 was $8.30.
10. Trash hauling services bill paid by check 1/31/91 was $40.40.
11. Telephone expense paid by check 1/31/91 was $42.00.
12. Gas bill paid by check 1/31/91 was $38.00.
13. Electric bill paid by check 1/31/91 was $277.20.
14. Advertising expense paid by check 1/31/91 was $170.30.
15. Purchase contract payment paid by check 1/31/91 was $139.82. Interest was $14.82 and principal was $125.00.
16. Bank loan payment 1/31/91 was $156.04. Interest was $39.37 and principal was $116.67.
17. Sales income deposited 2/28/91 was $10,738.68.
18. February wages paid 2/28/91 were $2,000.00. Withholding was $469.30 and net wages were $1,530.70.
19. Payroll taxes paid 2/28/91 were $469.30. Employer's FICA taxes were $117.06.
20. February rent paid 2/28/91 was $755.00.
21. Food purchased on account 2/28/91 was $2,138.40.
22. Paper products purchased by check 2/28/91 were $95.20.
23. Cleaning services bill paid 2/28/91 was $30.80.
24. Trash hauling bill paid 2/28/91 was $40.40.
25. Telephone bill paid 2/28/91 was $42.00.
26. Gas bill paid 2/28/91 was $43.00.

Figure 13-21 The Corner Bakery transactions for first quarter, 1991

(continued on next page)

The Corner Bakery Transactions, First Quarter of the Year, 1991

(continued)

27. Electric bill paid 2/28/91 was $298.30.
28. Advertising expense paid 2/28/91 was $245.50.
29. Purchase contract payment 2/28/91 was $139.82. Interest was $14.82 and principal was $125.00.
30. Bank loan payment 2/28/91 was $154.73. Interest was $38.06 and principal was $116.67.
31. February sales tax payment 2/28/91 was $511.36.
32. Account payable paid by check 2/28/91 was $1,843.20.
33. March sales deposited 3/31/91 were $11,373.89.
34. March wages paid 3/31/91 were $2,000.00. Withholding was $376.75 and net wages were $1,623.25.
35. Payroll taxes paid 3/31/91 were $376.75. Employer's FICA taxes were $129.18.
36. March rent paid 3/31/91 was $755.00.
37. Food purchased on account 3/31/91 was $2,808.00.
38. Accounts payable payment 3/31/91 was $2,138.40.
39. Paper products purchased 3/31/91 were $123.81.
40. Cleaning services bill paid 3/31/91 was $23.30.
41. Trash hauling bill paid 3/31/91 was $40.40.
42. Telephone bill paid 3/31/91 was $128.72.
43. Gas bill paid 3/31/91 was $40.59.
44. Electric bill paid 3/31/91 was $317.24
45. Advertising expense paid 3/31/91 was $125.00.
46. Purchase contract payment 3/31/91 was $139.82. Interest was $14.82 and principal was $116.67.
47. Bank loan payment 3/31/91 was $153.4. Interest was $36.74 and principal was $116.67.
48. March sales tax payment 3/31/91 was $541.61.
49. First quarter depreciation posted 3/31/91 was $200.00.
50. March 31 inventory valued at cost was $530.36.

Figure 13-21 The Corner Bakery transactions for first quarter, 1991

CHAPTER 14

Interpreting the Scorecard

CHAPTER GOALS

- To introduce the concepts of records in decision making.
- To introduce the concepts of business ratios as decision aids.

KEY CONCEPTS

Business ratios – A way of comparing business items, a shortcut way to determine if additional information is needed.

Current ratio – A business ratio based on current assets and current liabilities.

Debt service ratio – Business ratio based on the percentage of income dedicated to debt payment.

Degree of solvency – Business ratio dealing with liquidity.

Leasing – Renting assets instead of purchasing them, this allows more capital to be used in other resources.

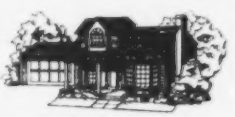
Liquid assets – Assets owned that can be readily turned into cash.

Purchase agreement – An agreement that lease payments apply to the purchase price.

Self-sustaining – Meeting all expenses on a current basis.

CASE STUDIES

Bjorn Buys a Backhoe



Bjorn had become a respected builder and was putting up three to five custom-built homes a year. One of the items he had leased when needed was a backhoe. The backhoe was used to excavate basements and to install water and sewer lines. One year a salesperson convinced him he needed to buy his own backhoe. He paid $20,000 for the equipment he could easily have rented for $500 per house.

The percentage of time it was used was small and the investment was high. However, Bjorn liked the idea of having it available at his convenience and purchased the new equipment.

Curtis Leases His Start-Up Equipment

Curtis decided to start up his own clinic instead of working for a set wage in another clinic. With his brother's help, his financial plan provided enough money to pay rent and wages until the clinic became **self-sustaining**. However, the finances did not provide sufficient funds for the expensive computer and x-ray equipment needed.

By **leasing** the equipment with a **purchase agreement** they were able to project sufficient operational funds to keep the clinic operating until income became adequate. The insurance payments from the patients' insurance companies were all delayed by the processing time needed for approval.

Notes from the Case Studies

1. Leasing equipment may help cash flow.
2. Records help when making rational decisions.
3. Financial projections are useful decision tools.
4. Projections need to be conservative.
5. Records should not be ignored in decision making.

RECORDS AID DECISION MAKING

Inventory Control

Past performance is the single most useful predictor of future performance. By reviewing what you sold in past periods, you are in the best position to gauge your inventory needs in the next period. The Corner Bakery, after reviewing the increasing sales each month, will undoubtedly start to increase its inventory of baking ingredients.

In a manufacturing or production activity the sales records dictate the need to plan production cycles far enough in advance to have the product ready for delivery when demanded.

Good inventory control provides adequate stock on hand with a minimum of capital tied up in nonmoving items. Use of the "just in time" delivery idea risks the loss of sales because the item could be temporarily out of stock. Customers may go to a competitor who has the item on hand.

Past records may not help much in keeping up with changes. For example, if you manage a shoe store a radical style may take off like a rocket or fall like a rock! Past records are more helpful in determining how much operating capital is needed each day, or how many pairs of popular shoes to keep in stock.

Investment in New Equipment

Records can help in deciding when to purchase new equipment. When delivery service records show that one of the vans is costing more in repairs and operating expenses than a replacement would, cash flow records can help determine the best time for the replacement expense.

If an additional van is needed, records of the peak use periods will indicate the best time to put it into service.

Today many companies lease equipment to businesses instead of outright sales. Is leasing a good idea for a beginning entrepreneur? This is not a simple question to answer. In some cases it may be a good answer, and in others it may not be.

Leasing is not a new idea, most businesses have rented (leased) their business locations. Perhaps the leasing of equipment is based on the same ideas. Let's look at two examples of equipment leasing and then you will have a better idea of the leasing question.

In the first case study, Bjorn began contracting houses and was building only a few each year. Was his purchase of the backhoe a good investment? (Remember, he is out of business.)

In the second case study, Curtis decided to lease so he would have enough capital to survive the early slow months and delays in cash flow from payment of patient's insurance claims. By leasing the equipment with a purchase agreement he could operate the office for the critical first six months. Was leasing in his case a good idea? You can bet it was! The clinic is now profitable.

A few final words about leasing – the leasing companies intend to make money, they are profit companies. Your leasing or purchasing decision should be based on the answers to the following kinds of questions:

1. Will your financial position support the purchase?
2. Will immediate availability and control mandate a purchase?
3. Will the equipment be available when needed if leased on an as-needed basis?
4. What will be the tax results in leasing or purchasing?
5. Will leasing result in greater profit?

BUSINESS RATIOS

Business ratios may or may not be a helpful shortcut to a more thorough analysis of a business as one tries to understand what is likely to happen in the future. Outsiders, such as bank examiners checking the bank's loan portfolio, may find ratios to be an effective way to rate the likelihood that the borrower's loan can be repaid. More specifically, the ratios may indicate when more information should be sought.

Ratios are based on actual or predicted performance. If you know the industry, you know if the ratio is indicative of a high or low performance measure.

The Degree of Solvency Measure

The **degree of solvency** ratio is a measure of the business' soundness over a period of time long enough to turn fixed assets into cash. For example, if a company has total assets of $235,000 and total liabilities of $75,000, the ratio is 3.13 or the company **owns** $3.13 for each $1.00 it **owes**. Bankers look at this as a good ratio.

Current Assets to Current Liabilities

The company discussed previously has **liquid assets** (those easily turned into cash) of $85,000. This company also has current liabilities (those payable within a year) of $57,000. The current ratio is 1.49 or $1.49 of current assets for each $1.00 of current liabilities. In financial circles, any time the **current ratio** is below 1.50 caution is advised and operating capital may be difficult to borrow. When the ratio nears 1.00 it indicates there is no cushion for any adversity or a slump in sales.

Debt Service Ratio

This same company has $18,000 of long-term debt – a mortgage. It pays $3,000 in principal per year on the mortgage and the current liabilities of $57,000. (The interest on the mortgage is included in the current liabilities.) The **debt service ratio** is computed as a percentage of annual income. If the company's annual sales are $385,000 and the total debt service payments total $60,000, the debt service ratio of 15.6 percent can be considered fairly secure. When the ratio is at or near 25 percent caution is advised. (You probably won't receive loans.)

Other Ratios

In addition to these ratios, other industries have their own specialized ratios. An example of a specialized industry ratio is the maintenance cost per mile for the delivery service. Cost of labor per unit of output is another example. In attracting investment in your business you may find ratios helpful.

ADDITIONAL READINGS

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2. Kamoroff, B. *Small Time Operator*. Bell Springs Publishing, 1991. pp. 125-137.
3. Swanson. *Accounting*. South-Western Publishing Co., 1992. pp. 191-207.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Using the financial reports from the Corner Bakery, compute each of the following ratios: the current ratio, the debt service ratio, and the degree of solvency ratio.
2. Using published balance sheets, figure the ratios.

Activities to Aid Decision Making

1. Using your balance sheet, figure the previously mentioned ratios.
2. Visit the loan officer at your bank and ask how the bank uses ratios.

Questions to Increase Your Understanding of the Text

1. How do records help you make inventory decisions?
2. How do records help you plan production schedules?
3. How can records help you spot trends?
4. When is leasing useful to an entrepreneur?
5. Are lease payments a deductible business expense?
6. What does a current ratio tell you?
7. What is a debt service ratio?
8. What information does a degree of solvency ratio tell you?

Questions to Aid Decision Making

1. Will my enterprise benefit from leasing?
2. Will my ratios encourage investment?

CHAPTER 15

The Question of Credit

CHAPTER GOALS

- To identify the advantages of using credit in a business.
- To identify the disadvantages of using credit in a business.
- To introduce the common types of credit.
- To identify the ways of managing credit.

KEY CONCEPTS

Annual percentage rate (APR) – The annualized percentage rate of the finance charge.

Bank cards – Credit cards issued by banks allowing customers to purchase items on credit. The bookkeeping and billing is completed by the banks for a percentage of the sale amount.

Collateral – Property pledged as security for a loan.

Collection agency – Organization that collects debts for a fee.

Collections – Obtaining payment of amounts due.

Credit – Obtaining goods or services on the basis of deferred payment.

Credit application – Written information gathered on a form to make the credit-granting decision

Credit Bureau – Organization providing credit information to businesses for a fee.

Creditor – Entity owed.

Credit policy – Rules indicating when to grant credit.

Credit rating – Estimation of repayment ability for a business or individual.

Durable goods – Items likely to have resale value.

Installment credit – Credit for a particular transaction to be paid in installments.

Lien – Monetary claim against property.

Line of credit – Borrowing arrangement which allows the use of a loan up to a given amount.

Open charge – Purchases are made on credit and paid for on agreed terms such as five percent discount if paid in ten days.

Revolving credit – Purchases are made on credit and payments are based on a percentage of the balance.

Truth-in-Lending Laws – Consumer protection laws requiring the full disclosure of terms in a credit sale.

CASE STUDY

Bill Buys a Pig in a Poke

Bill had been an entrepreneur for only a few months when Leo came in and asked to buy feed on **credit**. Bill's relationship with Leo was excellent. Before entering the feed business as a partner, Bill had taught Leo's two sons in high school. Unfortunately, Bill had not been alert enough to discover that Leo's farming operation was completely tied up by a **creditor** who was holding Leo's "purse strings." Bill did know that his business could not afford to provide long-term credit because of the cash flow problems it would create.

Leo's promise to pay when the load of hogs was to be marketed in three weeks was all Bill required as credit security. Bill's trust was misplaced because it took Leo eight months to pay for the feed.

Notes from the Case Study

1. The day of the handshake – "my word is my bond" – is usually history.
2. Credit requires adequate investigation.
3. Most businesses should not be in the credit business.
4. A **credit application** would have helped Bill's judgment of the risk.
5. Credit affects cash flow.
6. Credit can increase sales.
7. A **credit policy** is needed by any business.

BUSINESS CREDIT

Using Credit in Your Business

USING SUPPLIERS' CREDIT

Many of today's transactions between businesses are done on credit with shipping on an **open-credit** account. Invoices are either due on receipt, billed and net due in 30 days, or given a 5- or 10-percent discount if paid in ten days. This enables faster movement of goods and services. A new business, such as Bill's, has to establish credit to be able to order goods in this manner.

Bill started with an inventory of $12,000 in feed from his supplier and paid on delivery. On this basis he established a $5,000 credit line which enabled him to telephone the feed mill for delivery as additional amounts were needed.

CREDIT HELPS HANDLE EMPLOYEE BUSINESS EXPENSES

When Bill or his employee needed to travel to the mill for a rush order of feed because the local inventory was inadequate, they used credit cards to purchase the truck fuel. Bill used cards with the company name, thus allowing his employee to obtain needed services.

USING A LINE OF CREDIT

Many businesses operate on bank credit or borrowed money. As the business plan chapter pointed out, the plan has to be adequate to show the lender that the business is worth the investment of the capital. The financial plan spells out the operating capital needed and the time of year when it is needed.

In the case of Bill's business the peak use period for the **line of credit** was just before the year's end when payments from customers were slowest.

The line of credit is an agreement that the business can borrow up to the set limit as the money is required by the business. Because Leo's purchase ran eight months and Bill was using his line of credit, the sale was unprofitable. Bill gained credit experience rapidly.

Advantages of Credit Sales

The following items are common advantages of credit sales:

1. Credit increases sale volume.
2. Credit bonds customers.
3. Credit allows shipping on approval.
4. Customers can make one stop instead of two.
5. Credit information provides additional knowledge about customers.
6. Special purchases can be geared to credit customers.
7. Current credit builds goodwill.
8. Excess funds can earn a return through credit sales.
9. Customers who use credit are motivated more by service and quality than by price.

Disadvantages of Credit Sales

The following items are common disadvantages of granting credit:

1. Credit costs money.
2. There are extra bookkeeping costs.
3. Extra postage costs are necessary.
4. Interest costs are necessary.
5. Employee time must be paid for.
6. Credit requires more capital which, in a start-up business, is usually a scarce commodity.
7. There is a risk of loss. If no losses occur, the amount of credit extended is too low.

8. Some credit customers do not intend to pay.
9. Credit checks take time.
10. Economic bad times increase the risk of loss.
11. Some credit customers overstretch their payment capacity.
12. Credit customers are more likely to return items.

Common Types of Credit

OPEN CHARGE ACCOUNTS

Probably the oldest credit type of all is one of the simplest. The **open charge** account permits the customer to purchase items and pay for them on the terms agreed upon. These terms are commonly the following: payment due on billing; payment for a discount, such as 5 percent if paid in ten days; or the net figure in 30 days. For periods over 30 days a carrying charge of 1 to 1.5 percent per month is added.

INSTALLMENT CREDIT OR CLOSED-END CREDIT

"Closed-end credit" is credit for a particular transaction. Such credit is for a specific time limit and payments are on a set schedule. Car loans or mortgages fit this type.

Several variations of **installment credit** are known as easy payments, **revolving charge**, and proprietary credit. The easy-payment accounts are commonly used for **durable goods** such as appliances that have resale value, thus providing more security for the lender. Many of these contracts are resold to others rather than retained by the business. The payments are for a set number of months and the nominal interest rate misstates the true costs. This practice led to the **Truth-in-Lending Laws** governing credit today.

Revolving charge accounts are used by national chains to tie customers to their stores through the use of credit. These accounts typically offer monthly billing with required payments of only a small percentage of the balance with the rest carried at an interest rate of up to 21 percent **APR (annual percentage rate)**. They are expensive credit sources.

Bank cards or "plastic money" are in wide use by individuals as well as businesses. They provide businesses which have credit card agreements with card providers a means of offering credit with a minimum of risk. For a percentage of four to eight percent the credit card company assumes the risk, keeps the books, and bills the customer. The business, for that percentage, avoids the cash flow problems and the bookkeeping and billing tasks associated with credit.

Currently, card-issuing companies are competing for customers with several cards paying a small percentage return for each purchase made with their cards, in contrast to those still with APR's in the 21 percent range.

The Truth-in-Lending Laws apply to all retail credit including bank cards and requires the lender to fully disclose the terms. This disclosure statement requires the conditions under which a finance charge can be made, the minimum payment required, the interest rate charged, the corresponding annual percentage rate, how a purchase can be repossessed, and what liens apply to purchased items.

MANAGING CREDIT

Credit Applications

Most lenders require an application and credit investigation process. The credit application is used to determine the degree of risk involved in granting credit. The firm granting credit is trying to determine the repayment capacity, the collateral, and the character of the applicant. The application seeks identification information, financial information, and references. Major cities have **Credit Bureaus** that provide credit information to businesses for a fee.

Creating a Credit Policy for a Business

Before a business decides to offer credit to customers as a sales tool, a credit policy should be established and used. What are the elements of a workable credit policy? The following checklist will give you some idea of the items to consider when deciding to offer credit and what to place in the policy statement:

1. Business' cash flow position
2. Profit margin on items sold
3. Sales projection comparison with or without credit
4. Type of merchandise sold on credit – resalable if repossessed
5. Credit rating of the customer
6. Capital available
7. Possibility of using credit card agreements instead
8. Terms to establish for the credit
9. Who makes credit-granting decisions
10. Possibility of reselling the credit instruments
11. Credit terms for credit sales

Determining the **credit policy** of the business needs to be a priority because many businesses which are sound in the long run are sunk by cash flow problems in the short run. Businesses operating on a line of credit probably are better off reaching an agreement with a credit card company and paying that percentage rather than the loan interest.

As suggested earlier, durable goods are more appropriate for credit extension than nondurable goods and consumables. The ability to repossess and resell durable items reduces credit risk.

Collections

The prosperity or even the survival of businesses providing direct customer credit may depend on the ability of the credit department to make timely **collection** of credit accounts. Monitoring accounts for slow payment and no payment are monthly tasks.

Collection letters are a method used by some companies with varying success. If you choose such methods, the first letter might say, "We missed your payment . . ." The second could say "Your account is now in arrears, is there . . ?" The third can suggest recourse to forfeiture. The final recourse is to turn the account over to a **collection agency**. They make the collections for a high percentage of the funds collected. It is also wise to note that there are strict consumer protection laws that can limit collection methods.

The telephone can also be used in the collections effort with the first call (on private lines only) merely suggesting a possible oversight. With each additional call the tone can get more forceful. The advantage of the telephone is direct communication and the rapid sharing of information.

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3. Meyer, W. G. *Retail Marketing*, Gregg Division McGraw-Hill Book Company, 1993. pp. 381-393.
4. Wyllie, E. D. *Consumer Economics*. South-Western Publishing Co., 1992. pp. 202-223.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Reread your credit card agreement and summarize its terms such as APR for balances carried forward, required payments, and similar items.
2. Obtain a credit application and study its language.
3. Write a credit policy for Bill's feed business.

Activities to Aid Decision Making

1. Check with credit card companies to see if you can obtain an agreement to use their cards for your business.
2. Write a credit policy for your business.
3. Calculate the cost of using credit card company agreements and how costs compare to expected increases in sales.

Questions to Increase Your Understanding of the Text

1. What are the advantages of offering credit?
2. What are the disadvantages of offering credit?
3. How does credit affect cash flow?
4. What are the common types of credit?
5. Why are credit applications useful?

Questions to Aid Decision Making

1. Does your business have surplus cash to invest in credit sales?
2. Are your products resalable if repossessed?
3. Can you obtain a credit card agreement for the business to accept credit cards?

CHAPTER 16

Managing Cash Flow

CHAPTER GOALS

- To identify the cash flow budgeting concepts.
- To introduce the lender's viewpoint.
- To identify scheduling as a part of cash flow budgeting.

KEY CONCEPTS

Accounts receivable – Money owed the business.

Bad debt – A debt that is considered uncollectible.

Cash flow budgeting – Estimating the income and expenses for a given time period.

Cash flow crisis – Expenses exceeding cash on hand.

Equity funds – Funds generated by ownership in the business.

Inventory – Listing of resources.

Long-term credit – Credit to be repaid in a term longer than one year.

Short-term credit – Credit to be repaid within one year.

Trade credit – Suppliers shipping on open account.

CASE STUDIES

June Buys an Unadvertised Business

A mutual friend told June Baylor that the Richies were interested in selling the flower shop in a mid-sized city, but didn't want the hassle of a brokered deal. June and her husband had been quietly looking for an opportunity and the flower shop sounded like a suitable opening. Their children were in elementary school and they were interested in developing a business to help pay college expenses. Three months later June and her husband owned the business.

The sale came about because of Mr. Richie's retirement and Mrs. Richie's health problems. They had owned the business for more than 20 years. Mrs. Richie agreed to stay on for one full month to aid in the transition. All employees were retained and the real estate was purchased.

June's husband, Rocky, was the computer teacher at an area high school, and as a result, one of the first items of business was to computerize the business. Rocky became the accountant and June the managed the store.

The Baylors took a number of actions to preserve cash flow during the first few months of ownership. By putting all accounts into a computer accounting system the resulting inventory control allowed smaller orders to hold down the amount of cash tied up in inventory. Computerization also allowed faster turn around in billing commercial customers constituting about 20 percent of the shop's business. Immediate billing reduced the amount of cash tied up in accounts receivable.

The computers made another innovation possible. A reminder notice was mailed to husbands at their business addresses to remind them of birthdays and anniversaries. These dates were flagged by the computer 10 days in advance.

To reduce fixed costs, the Baylors decided to sell the second vehicle which was part of the purchase deal. The remodeling of some excess space into offices for rental at $350 per month also aided cash flow. Another decision that reduced immediate costs was not to change the name of the business. Some of the costs of such a change would be signs, phone directory changes, letterheads, invoices, and sales slips to be reprinted immediately instead of as needed.

Bill's Cash Flow Crisis

Remember Bill? He had a line of credit at the mill for a regular truckload of feed. One day in late September he took Arnold to the nearby coffee shop and they were discussing the three carloads of feeder steers in Arnold's feedlot. Bill had been talking with Arnold on the farm and sold him a trial load of beef protein supplement. The cattle were doing well and Arnold had decided to use the program for all his beef cattle. At that time of year the feed company was conducting a bulk feed promotion worth $10 a ton off the regular price. Bill sold Arnold 60 tons of feed over one cup of coffee!

Arnold was pleased at the price, Bill was pleased at the sale; however Bill's problem was only beginning. Just before meeting with Arnold, Bill had ordered enough feed to nearly exhaust his credit limit at the mill. Then he had to order the first delivery of bulk feed for Arnold because it was needed in the next five days. Since late fall is the slowest time for his business' **accounts receivable**, Bill went to his banker for an increased line of credit. As a former teacher in the local school his character reference was excellent, but his financial rating was not strong enough to raise the business' line of credit.

However, to handle the immediate need, Bill delivered the first ton of feed from **inventory** on hand at the bulk price. Thus he bought two weeks of time to solve the cash flow problem. In addition, Bill's silent partner, Howard, was pleased with the sale. Howard was worth more than a million dollars; consequently, when he went to the bank there was no question about the increase in the line of credit. He simply told the banker to take care of the business' credit needs or he would find another bank for his personal business.

The successful completion of this 60-ton order resulted in the credit limit at the mill being tripled! Thus preventing what could have been Bill's next **cash flow crisis**.

Notes from the Case Studies

1. Some businesses frequently have cash flow problems.
2. In a seasonal business cash flow is a special concern.
3. Computers speed the paperwork of billing.
4. Credit limits are frequently negotiable.
5. Prudent management actions can aid cash flow.
6. Changing a business' name can affect cash flow.
7. A transition period aids a business change in ownership.
8. Large inventories tie up cash.
9. Slow accounts receivable tie up cash.
10. Extra services build business.
11. Rental of unused space aids cash flow.
12. Some financial crises are really **managerial**.
13. Many businesses are under-funded.

CASH FLOW

A cash flow report is the record of cash revenues and disbursements. If all cash is put in a bank account, the monthly bank reconciliation report is a cash flow report for each month. All persons and all business entities must "cash flow" if they are to avoid bankruptcy. Everyone must somehow pay their bills.

Projected cash flow reports, from now to specific future dates, are helpful to an entrepreneur as he or she chooses what to buy and sell in order to meet financial obligations. A lender is interested in evidence of how a business' cash is projected to flow. Lenders don't want to spend the time or money to close a business in order to collect the loan.

When comparing various financing and production recipes for your business, you should select that combination of recipes that you think will make you the most profit. However, you **cannot** select any recipe combination that you **cannot cash flow**, even if it appears to be profitable. **If you can't cash flow it, you can't do it!**

Plan carefully before buying anything. Be especially careful about committing to purchase assets with slow reproductive use. For example, unless you have excess cash or can get very long payment terms, don't buy land or other real estate.

Recognize that in our market economy, other persons have excess funds. They are willing and able to own real estate and rent it out. Depositors place their excess funds in lending institutions for other lenders to perform their services. These institutions earn profits by charging businesses more interest than they pay depositors and the people who invest in banks. If the people in the lending institutions perform their services at a low cost, they realize a profit. This profit is distributed as dividends to the bank's stockholders or owners.

Forecasting Cash Flow

The cash flow crisis is a symptom of inadequate management and may be one of the main causes of business failures. SCORE counselors report that too often small businesses report financial problems that are actually management problems. This management problem is a lack of planning.

What causes the problem? Typically small business owners know their line of business. Their technical knowledge is first-rate, but their management skills are undeveloped. They fail to plan ahead because they are concerned with current instead of future operations. Usually, they believe money will solve the cash crisis.

The first three goals for a new (or any) business are the following:

Goal #1 – **Survival!**

Goal #2 – **Survival!**

Goal #3 – **Survival!**

THE LENDER'S A B C'S OF LENDING

The lender's A B C's of loaning money are the following:

A. Accountability and ability to repay

B. Balance sheets and income statements

C. Character and collateral

The bank's first responsibility is to the depositors. It is held accountable through the examination of its lending portfolio by the state's banking authority. As has been said, "the loan that is easiest to get is the one that is not needed." The bank's goal is to make a profit by making sound loans.

Sound loans are ones that are repaid! The ability of the borrower to repay the loan and its interest must, therefore, be a prime concern for the bank or lender. A good loan is also one that enables the business, and thereby the community, to grow and prosper. A failure to provide assurance that the loan will be repaid in a timely manner may reduce to zero the chances of its being granted!

Balance sheets and income statements are important because the best predictor of future performance is the record of past performance. When such records are absent, as in a start-up business, cosigners may be enough to obtain the loan. But remember – a large percentage of cosigners are called upon to make the payments! Projected balance sheets and cash flow are examined. The ratios we discussed in an earlier chapter may be one way these statements are evaluated.

There probably is no substitute for character in the loan application. It will always be one of the intangibles that play a part in the decision-making process. However, it alone does not guarantee the approval of a loan application. The second "C" for collateral greatly influences the lender's decision. Evidence that there are adequate salable assets to recover the loan principal and interest plays a big part in any decision.

Finally, the lender will ask the following two questions concerning company management:

1. Does the management know the right recipes?
2. Does the management make the recipes right?

In reviewing the loan application the lender will ask what the money will be used for. Your business probably uses several kinds of money and each should be recognized and applied properly. These types of money are the following:

Trade Credit – This is the money you pay suppliers who ship to you on an open-account basis. Your past performance – bills paid within the terms of the account – is evidence of repayment ability.

Short-term Credit – This is short-term loans that are to be paid within the year. Loans for inventory buildup should be self-liquidating through sales that generate funds.

Long-term Credit – This is money to expand the business, modernize, upgrade, or move into new areas. It should be financed over a period of time longer than a year. Profit projections should show evidence of repayment ability.

Equity Funds – Investors receive part ownership in the business through partnerships or corporate shares. This money is not loan funds to be repaid. Income generated above costs is returned in increased equity or dividends.

When you are looking for more capital, realizing the type of money needed is the start of the financing effort. Examination of your cash flow projections, income statements, and balance sheet determines if sufficient cash is being generated to repay a loan, or if the cash needed for operating capital is being diverted into long-term items such as facilities and equipment or other areas of the business.

The first case study presents several management decisions which help preserve liquidity. They are the following:

1. Selling a fixed asset
2. Converting unused space into income-producing space
3. Computer-aided inventory control
4. Computer-aided billing
5. Computer-aided sales promotion

CASH BUDGETING

Start your cash budgeting with your family living expenses. If you have a record of last year's expenses, start by charting them. Then work out a detailed plan for the next 12 months, it does not have to coincide with the calendar year. Use the expenditure list in Figure 16-1 to get started. (Using a columnar accounting pad will be helpful.)

Most beginning entrepreneurs consider forecasting the cash flow to be a difficult task. Take a look at the cash flow for the Corner Bakery presented in Figure 16-2. Note that the first month starts with a cash-on-hand balance. The income and expenses are detailed and an ending balance is shown that becomes the opening balance for the next

month. The numbers in parentheses indicate a negative balance and the borrowing need for that month. Good management recognizes that borrowing is a management tool used for appropriate reasons.

FAMILY BUDGET PROJECTION

Family Living 19XX

Expenditures	Month 1	Month 2	Month 12	Totals
Food				
Clothing				
House payments				
Home repairs				
Furnishings				
Utilities and fuel				
Education				
Recreation				
Transportation				
Health				
Personal care				
Health insurance				
Life and other insurance				
Savings				
Gifts and donations				
Other expenditures				
TOTALS				

Figure 16-1 Family living budget

Three items must be observed in the process: first, the sales projections need to be realistic and obtainable; second, variable costs must relate to the sales figures forecasted; and third, some reserve for the unexpected should be factored into the forecast. Most authorities recommend that 5 to 10 percent of the business' capital be in cash in order to prevent continuing cash flow crises.

To start your own cash flow projection, set up your form similar to Figure 16-2 and enter the data. You need to identify the items that relate to your business such as specific utilities, equipment rentals, and like items. Figure 16-2 is shown merely as a "how to" example. The Corner Bakery categories fit a bakery business, yours should fit your business.

CASH FLOW PROJECTION

Items	Initial	Month 1	Month 2	Month 12	Totals
Fixed Expenses					
Rent					
Utilities					
Insurance					
Variable Expenses					
Advertising					
Inventory					
Sales commissions					
Transportation					
Office supplies					
Total Cash Needed					
Income					
Beginning cash balance					
Sales					
Services					
Total Cash Available					

Figure 16-2 A cash flow worksheet

You know your fixed costs; the variable costs are related to the volume of sales achieved by your business. Projections are based on realistic goals; try not to overestimate sales or underestimate expenses. Your knowledge of the business should guide your estimates. You may want to use two columns for each month so, as the business moves from month to month, you can enter the actual figures to check and refine your projections.

No one can accurately predict future events, so don't become discouraged at the discrepancies that occur. Experience in estimating these items sharpens your future predictions.

Setting Up a Line of Credit

You start the process by identifying your needs. Your cash flow projections provide this information. To graphically see the relationship of cash flow to business activities, we use the following cash flow circle, Figure 16-3.

What are the causes of cash flow problems? Successful cash flow management involves the control of the following items:

1. Fixed costs creeping upward
2. Variable costs getting out of control
3. Sales not turning into cash fast enough (accounts receivable over 90 days old)
4. Overloaded inventory
5. **Bad debt** losses

When you match your cash flow cycle with your cash flow projection budget, you have the basis for talking to a lender. You know which kind of money is needed, when it is needed, and how it will generate funds to repay the loan.

SELLING THE LENDER

In *Borrowing for Your Business* George, M. Dawson says there are seven questions you must answer in order to have a loan approved. We have rephrased them as the following:

1. How much money do you require?
2. What are the purposes of the loan?
3. How will the loan help your business?
4. Why do you need the money?
5. When will you pay it back?
6. How will you be able to pay it back?
7. What if your plans fail?

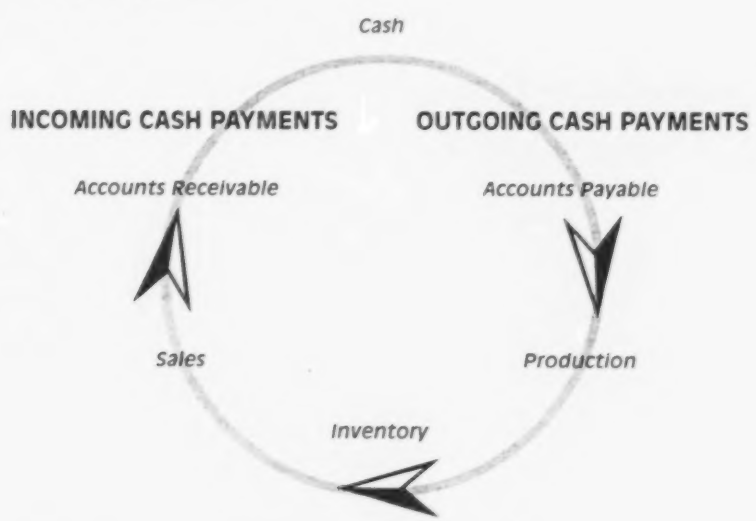


Figure 16-3 The cash flow circle

Write the proposal that answers these questions and then go to the lender. When the loan committee decides to make the loan, you then negotiate the conditions, provided those proposed by the lender are not acceptable to you. (Recognize that lenders are buying your credit. Only after they say "yes" do you need to commit to signing for the loan. Even after you get a loan, you may decide not to take it!)

Some of the items that have not been discussed, but will govern these conditions include the lender's perception of your credit history, your account history, and knowledge of the industry. Your proposal may need to assume the loan officer knows nothing of the business. Avoid patronizing, but inform the loan officer. Any unexplained items on the financial statements are given the lowest ranking, not the highest.

Scheduling as a Cash Flow Aid

In a manufacturing business, scheduling the receipt of raw materials and the shipment of orders sold can be scheduled so inventories are kept at a minimum. In retail establishments, computer inventory control can trigger reorders when a certain number remaining on hand is reached. In some cases businesses may set this reorder level too low and, consequently, lose sales because the supply is exhausted before restocking occurs. How many times have you heard, "We can have it here in two or three days"?

In a service business, the setting of payment terms can be dependent on job completion. For example, on an order for installed kitchen cabinets, a percentage of up-front money could be collected and the cabinets' delivery scheduled for the available installation time. Experience will improve your scheduling abilities.

ADDITIONAL READINGS

1. Anders, R. L. *Managing Small Businesses.* West, 1993. pp. 418-427.
2. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 155-164.
3. Meyer, W. G. *Retail Marketing.* Gregg Division McGraw-Hill Book Company, 1993. pp. 547-554.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Interview a bank loan officer and ask questions about how the loan committee decides on which loans to grant.
2. Look at the cash flow projections of the new owners of the Corner Bakery and decide how realistic you think they are.

Activities to Aid Decision Making

1. Do a cash flow projection for your business, by months for the first year and by quarters for the second.
2. Look at Figure 16-3 and define the cash flow cycle for your business.

Questions to Increase Your Understanding of the Text

1. What do we mean by the term **cash flow**?
2. What are the things that impact cash flow most severely?
3. What percentage of assets should be cash?
4. Why should budgeting start with family living expenses?
5. Why should the cash flow projection list fixed costs first?
6. What are the A B C's of borrowing?

Questions to Aid Decision Making

1. Does your business have enough start-up capital to survive the cash flow crises of the start-up period?
2. Does your business plan pass the A B C's of borrowing test?

CHAPTER 17

Business Taxes

CHAPTER GOAL

- To introduce business taxes.

KEY CONCEPTS

Accrual method – Expenses are recognized when obligated, and income when the sale is made regardless of when the payments are made.

Audit – Exacting examination of the records.

Cash method – Income and expenses recognized at payment.

Document – Provide necessary verification or proof.

Income tax – State or federal tax on personal income.

License – A fee paid to operate a certain business.

Payroll taxes – Taxes deducted from a worker's pay.

Sales tax – Tax on sales of goods or services.

Taxable – Subject to a tax.

Taxes – Money raised by levies to pay the cost of government services.

Withholding – Payroll taxes.

CASE STUDIES

A Friend's Good Intentions

Emil's friend, Pat, had been doing her own individual **taxes** for years. In addition, she often helped friends with their tax forms. After Emil opened his small furniture store, Pat told Emil that she would help him with the taxes for his business. However, when it was time to file the business taxes, both decided they needed a little more help.

After consulting professionals, Emil learned that he had to provide information that he had not known he needed to record. As a result, he had to pay more taxes because he could not **document** all the expenses he could have otherwise deducted.

In order to avoid future mishaps, Emil and Pat jointly visited their Internal Revenue and State Department of Revenue offices for free advice on what they would need for the following year. In addition, they also attended a seminar on tax concerns for new businesses (this seminar was sponsored by the SBA - Small Business Administration). Each of the free services provided them with further insights and copies

of tax forms for different aspects of the small furniture store's taxes. By year's end Emil had learned about tax matters, and with adequate records and documentation for his business, was able to file his own taxes.

Ignorance Is No Excuse

Kanisha began a fire extinguisher maintenance and repair service from his basement. Three years later he was contacted by his state's Department of Revenue concerning a **sales tax audit**. Kanisha thought it was unusual since he didn't charge any sales tax in his work. During the audit it became apparent that he indeed owed the tax. While the labor portion for his service was not subject to sales tax, parts, materials, and chemicals to recharge the extinguishers were **taxable**. In addition to sales tax money owed, he was assessed penalties and interest for late filing and late payment.

Notes from the Case Studies

1. Check with tax authorities before starting a business.
2. The Internal Revenue Service is free and has an 800 number.
3. Identify the needed records and how tax laws apply.
4. Maintain an organized record system.
5. Friends may not know all the facts.
6. The burden of proof is on the business owner.
7. Advance preparation saves time and money.
8. Errors and omissions can cost penalties and interest.
9. Preventing tax problems is less costly than incurring interest and penalties.
10. If you choose to do your own taxes, invest the time to learn properly.

UTILIZING AVAILABLE TAX RESOURCES

Records Aid Tax Preparation

Income and sales tax reporting are really just another component of effective record keeping. The more complete and accurate your records are, the easier it is when the time comes to pay the business taxes. The often complex and seemingly confusing issue of business taxation can be greatly clarified if you are well informed about federal, state, and local tax laws. An entrepreneur has many free resources available through federal and state tax and revenue offices which the business person can use. Professional tax preparation individuals and companies are also available for the people who do not want to prepare their own taxes.

The same entrepreneurial spirit that prompted you to start an enterprise may also motivate you to invest the time to learn all you can in order to create and maintain the success of your venture. Since your two most

insufficient resources for your business are likely time and money, the investment of some of that time in learning about tax laws as they apply to your business may be a profitable investment. You do not need to become an expert on tax laws, but you should be informed on the basic requirements and filing deadlines.

Where to Get Help

Ignorance of the law is dangerous and works to your disadvantage. Most people claim that they don't have time to attend seminars or go to workshops. Even though your time is limited or "scarce," use it wisely. Non-payment of required taxes or non-filing of required tax returns results in penalties and interest which are more costly than obtaining the necessary permits and paying the taxes on time. Take the time to learn how to avoid costly mistakes. Error prevention is more cost effective than finding a cure for an existing problem.

In addition to federal taxes, you may be required to pay state and/or local taxes as well. The list in Figure 17-1 is a general guideline for tax filing requirements.

General Federal, State, and Local Tax Notes

Tax	Notes on Deadlines
FEDERAL TAXES	
Income tax	April 15
Payroll taxes	Check IRS Circular E
Unemployment tax	Quarterly deposits, annual filing
STATE TAXES (where applicable)	
Income tax	Varies by state
Employee withholding and sales taxes	
LOCAL TAXES (where applicable)	
Income tax	Varies by locality
Employee withholding and sales taxes	

Figure 17-1 General tax notes

Federal income tax **withholding** is a responsibility of every employer with employees. In addition, Social Security and Medicare taxes are included. In all but a few states there is also a state **income tax** withholding law. In most states sales taxes must be collected and reported on a regular basis. In a number of states local taxes by city or county are levied. Sometimes these taxes are collected by the state and returned to the local government. Contact your state's revenue department for your business.

If your business has employees, you are obligated to collect and remit employee withholding taxes. To meet this obligation you need employer and employee identification numbers. Contact the IRS at their 800 number to obtain your employer identification number. When reporting employee tax information, use Forms 940 and 941 to report unemployment, income tax withholding, social security, and Medicare taxes. File Form 941 quarterly and Form 940 annually. Each of these require periodic deposits of taxes due. Employers must withhold federal income taxes as well as FICA and Medicare taxes from employees' wages. In addition to these amounts withheld, employers must match FICA and Medicare taxes. These amounts are paid through federal tax deposit

coupons and deposited at local banks. All of these taxes are reported on Form 941, Appendix F. Unemployment taxes are reported on Form 940, Appendix G. State withholdings are reported on their forms based on state laws. Needed forms are provided on request for the first filing and are normally supplied to you continually thereafter.

Your local Small Business Development Center can help acquaint you with the needed information concerning contacts. See Chapter 22 for more information if local sources are not available.

A major source of information about taxes is the Federal Internal Revenue Service (IRS). The IRS publishes a wide variety of materials on both general and specific aspects of personal and business taxation. You can obtain a free copy of any of these and the needed tax forms by visiting your nearest IRS office listed in your telephone directory, or by calling the IRS toll-free service at 1-800-829-3676. We suggest you visit your local IRS office to obtain the forms and information you need. Do this as early as possible in the initial stages of setting up your business. This will facilitate your record keeping procedures since you will know beforehand which records you will need for filling out your tax forms.

The IRS maintains an information line at 1-800-829-1040. They will not do your taxes for you, but they do provide many services. Among these are the following programs of tax education:

1. Community Outreach Tax Education
2. Volunteer Income Tax Assistance
3. Small Business Tax Education
4. Bank, Post Office, and Library Programs
5. Practitioner Education
6. Understanding Taxes

The IRS also makes available to local libraries a series of video cassettes concerning specific tax topics entitled *Tax Tips on Tape*. Any of these or other films, videotapes, or published materials may be obtained or borrowed from any local IRS office.

Additional sources of information include the Small Business Administration (SBA) which offers many publications to those interested in small business ownership and management. This organization makes each publication available at a small cost. To obtain a list of their materials (SBA Publication 115-A) contact your local SBA office or write to:

Small Business Administration
Office of Business Development
1411 L Street N.W.
Washington, DC 20416

Other publications including subject bibliographies, *Small Business* (SB-307), and *Business and Business Management* (SB-004) are available free by writing to:

Superintendent of Documents
Washington, DC 20402

Another source to contact is the Small Business Answer Desk at 1-800-368-5855 (Monday through Friday 9:00 A.M. to 5:00 P.M. Eastern Standard Time) or 653-7561 in the Washington, DC area. This is a

nationwide service to help small business owners with any problems they may have. It can also refer you to appropriate governmental agencies, trade associations, and other information services.

The Service Corp. of Retired Executives (SCORE) and Active Corp. of Executives (ACE) provide counseling and SBA-sponsored pre-business workshops. The SCORE answer desk may be reached at 1-800-368-5855 toll free.

The Social Security Administration (SSA) provides information on how to report social security wages for paper and electronic filing. SSA also conducts free seminars.

There are national business, professional, and trade organizations which publish magazines or provide services to their members. Some examples include the following:

1. National Federation of Independent Businesses (NFIB)
2. National Association of the Self-Employed
3. National Association of Independent Contractors
4. US Chamber of Commerce
5. National Society of Certified Public Accountants

FEDERAL AGENCIES

U.S. Department of Agriculture – Cooperative Extension Service County Agents provide workshops, counseling and other assistance to rural residents managing small businesses and farms.

U.S. Department of Labor – Employment Standards Division helps with labor and wage relations and other labor management standards.

U.S. Department of Commerce – Minority Business Development Agency supports the development of minority owned and managed businesses.

State and local agencies provide information on local and state laws and regulations regarding businesses and their owners and managers. Contact your state or local Chamber of Commerce for assistance in identifying the agencies which may be most helpful to you. They include the following:

1. State Department of Revenue, Taxation, or Equalization
2. State Department of Commerce or Minority Business Development
3. State Employment Commission or Employment Security
4. State Department of Economic Development or Business Regulation
5. Governor's Office of Community and Industrial Development
6. Governor's Office of Minority and Small Business Development
7. Small Business Development Center or Small Business Resource Center

Other important sources of information include a library, attorney, certified public accountant, enrolled tax agent, professional tax preparer, city clerk, county treasurer, and the Secretary of State's office. Contact with these sources leads to additional sources of information as well. For example, if you start a restaurant they will refer you to the Department of Health.

TAXATION RECORD KEEPING

Required Records

There are some key aspects of record keeping which apply to taxes. Any deductions taken for business property, travel, transportation, entertainment, business gift expenses, and similar items must be documented with a log or receipt. If, for example, you operate a business out of your home or garage, you must be able to specifically identify which portion of all your bills (e.g., electricity, phone, rent) is dedicated to that business. List home office expenses on Form 8829, Appendix E. Publication 552 titled *Record Keeping for Individuals* should be helpful.

You also need to identify the sources and dates of all your receipts. For all businesses, the IRS suggests keeping a record book of all deductible expenses with dates, receipts, mileage, and brief but understandable explanations so you don't overlook any deductions and are able to document them. By law you must keep all applicable records for "as long as they may be material in the administration of any Internal Revenue Law." For income and deduction records this means that all records must be kept for at least three years (two years from when the tax was paid, whichever is later). This is when the statue of limitations ordinarily expires for income tax returns. Other records must be kept indefinitely, for example, those for which it is necessary to determine original or replacement property and those which also show adjustments when a business changes accounting methods.

Reporting Income Tax

By law you must keep records. If your business reports income and deductions in the year they are received or paid out, then you must report them as income and deductions on that year's 1040. This is known as the **cash method**. The second way in which you may report income is through the **accrual method**. This method reports income in the year in which it was earned, and expenses when they were incurred regardless of when payment was received or made.

The actual tax forms your business uses may change frequently. However, we believe the current forms will be useful to help you understand taxes and become familiar with reporting income, deductions, and profits when you prepare your federal tax forms.

Figure 17-2 illustrates a checklist of taxes and tax forms for which the different types of businesses may be accountable. The first column shows the different taxes for which the business may be liable. The second and third columns show which forms each business uses. The fourth column gives the due date.

CHECKLIST

A sole proprietor, a corporation, or a partnership may be liable for some of the federal taxes listed in the following text. If a due date falls on a Saturday, Sunday, or legal holiday it is postponed until the next day that is not a Saturday, Sunday, or a legal holiday

Checklist of Possible Tax Liability

You May Be Liable for:	If You Are:	Use Form:	Due On or Before:
Income tax	Sole proprietor, individual who is a partner or S-corporation shareholder	Schedule C, F 1040	Same day as Form 1040 15th day of 4th month after end of tax year
	Corporation	1120 or 1120-A	15th day of 3rd month after end of tax year
	S-corporation	1120S	15th day of 3rd month after end of tax year
Self-employment tax	Sole proprietor, or a partner	Schedule SE Form 1040)	Same day as Form 1040
Estimated tax	Sole proprietor, partner, or S-corporation shareholder	1040-ES	5th day of 4th, 6th, and 9th month of tax year and 15th of 1st month after end of year
	Corporation	1120-W	15th day of 4th, 6th, 9th, and 12th months of tax year
Annual return of income	Partnership	1065	15th day of 4th month after end of tax year
Social security (FICA) tax and withholding of income taxes	Sole proprietor, corporation, S-corporation, or partnership	941	4-30, 7-31
		8109 (to make deposits)	10-31, and 1-31 (See Chapter 34)
Providing information on social security (FICA) tax and the withholding of income taxes	Sole proprietor, corporation, S-corporation, or partnership	W-2 (to employee)	1-31
		W-2 and W-3 (to the Social Security Admin.)	Last day of February
Federal unemployment (FUTA) tax	Sole proprietor, corporation, S-corporation, or partnership	940, 940-EZ	1-31
		8109 (to make deposits)	4-30, 7-31, 10-31, and 1-31 but only if tax liability is more than $100
Information returns for payments to non-employees transactions with other persons	Sole proprietor, corporation, S-corporation, or partnership	1099-MISC (See Chapter 37)	To recipient by 1-31 and to IRS by 2-28
Excise taxes	Sole proprietor, corporation, S-corporation, or partnership	(See Chapter 36)	See the instructions to the forms

Figure 17-2 Checklist of possible tax liability

(Adapted from IRS Publication 334, *Tax Guide for Small Business*.)

A sole proprietorship must report its profits and losses on a Schedule C of Form 1040, Appendix D. This schedule allows you to subtract deductible expenses from gross income in order to determine your business' profit or loss. Payments for contracted labor, outside services, or rent paid to non-incorporated persons or entities must be documented with a Form 1099. This form, Appendix H, must be sent to each of the appropriate recipients for any of the services which resulted in payments of $600 or more in a calendar year.

If, for example, you rent business space from an individual for $1,000 and pay an outside company $700 for janitorial services, you need to issue each of these a 1099 reporting the amounts paid. These expenses can be deducted on the Schedule C if your business is a sole proprietorship.

Employees may not be treated as subcontractors to avoid the withholding laws. Such employees can file an SS-8 form, Appendix I, to determine if they do qualify as employees. If they are judged to be employees, IRS levies penalties, back taxes, and interest on the business in question.

If you are self-employed you must pay a self-employment tax in place of the social security normally withheld from an employee's wages. If you earned $400 or more of net income from one or more self-employment sources, you need to calculate the tax on Schedule SE, Appendix J.

Some sole proprietors, partners or S-corporation shareholders must also pay an estimated income tax during the course of the tax year. This tax is the amount over $500 by which the total of your estimated income tax and all self-employment tax exceeds the tax you expect to have withheld from any wages. The Form 1040-ES and its worksheet, Appendix K, can show if you need to make quarterly tax payments.

Reporting other Taxes

Many states and some local governmental units collect other taxes. Because taxes in individual states are varied, we will not attempt to list them here, instead we recommend you obtain the information and forms needed from the appropriate revenue departments.

Although tax matters may seem complex and confusing, time invested in visits to some of the many free services offered by federal and state agencies or other organizations helps clarify these issues. In addition, most libraries have a number of resources to enable you to become informed on tax matters. This information will help you whether you do your own taxes or hire a professional. We believe it is less expensive to stay out of trouble than to get out of trouble after a mistake.

ADDITIONAL READINGS

1. Abrams, R. M. *The Successful Business Plan: Secrets & Strategies.* Oasis Press, 1991. pp. 203-209.
2. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 183-188.
3. Jenkins, M. D. *Starting and Operating a Business in Indiana.* Oasis Press, pp. 8-14.
4. Kamoroff, B. *Small Time Operator.* Bell Springs Publishing, 1991. pp. 87-99.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Assume the Corner Bakery is an S-corporation; obtain the needed tax forms and complete the first year's taxes.
2. Visit your local IRS office to obtain the forms.
3. Visit your local library and view the materials provided by the IRS.

Activities to Aid Decision Making

1. Call the IRS 800 number and request the tax forms your business will require.
2. Visit the State Revenue Department and Internal Revenue Service offices and obtain the state and federal forms your business will require.

Questions to Increase Your Understanding of the Text

1. What are the possible results of poor documentation of business expenses?
2. What valuable help is available from the following:
   IRS?
   State tax authority?
   Small Business Administration?
3. How is a determination made if an individual is an employee or independent contractor?

Questions to Aid Decision Making

1. What forms will be needed by my business?
2. How do I obtain needed permits?

PART V

Managing Small Business

BEST COPY AVAILABLE

CHAPTER 18

Delegating Details

CHAPTER GOALS

- To identify procedures to follow in hiring employees.
- To identify the elements of a job description.
- To identify the components of an employment application.
- To identify the elements of an employee training plan.
- To identify the elements of an employee incentive plan.

KEY CONCEPTS

Adversarial relationship – Opposing.

Application – Request for consideration.

Incentive – Inducement for superior performance.

Interview – Personal conversation to determine a hiring decision.

Job description – Listing of qualifications or skills for a given job.

Orientation – Acquainting a new employee with the job and the company.

Proprietary – Owned by the company.

Stock shares – Partial ownership of the business.

Training – Preparing new employees to do the job your way.

Word-of-mouth – From one individual to another.

CASE STUDY

Doug Does Double Duty

Doug started a small business – trucking farmers' livestock and grain to market. Soon he was busy with more jobs than time permitted him to handle by himself. Fortunately, one of his best customers had a son, Bob, who was underemployed on his home farm. Since another person would greatly speed up the operation and allow more trucking jobs to be completed, Doug hired Bob as an assistant.

Thus, Doug had his first experience in hiring an employee. Since it was on a casual, one-job-at-a-time arrangement, no problems occurred. Soon it became apparent that if he wanted to reduce the number of long

working days, he would need more than occasional help. Also, he did not trust his older model truck on long trips anymore. He considered hiring another driver for the short run and purchasing a new truck for the long hauls. (Many of his customers preferred a livestock market in an adjoining state.)

He talked to Bob and his father, but they thought the extra work would be too time-consuming for their farming operation and turned down the offer. Doug then hired another young man and soon found customers telling him that if he couldn't come in person they would call someone else. They said the new driver did not know how to handle their livestock. Doug faced the problem squarely and terminated the new driver. After looking at his peak scheduling times and his slow scheduling times, he discovered that when Bob and his dad were the busiest, he was not. So Doug made a new offer to them; a suitable arrangement was made; and Doug's business grew.

As the business continued to grow, Doug again located underemployed farm people and began using them as helpers for both himself and Bob. One person was Donna, a very active 4-H alumni. She came to Doug and asked for a chance. Since Doug had trucked many of her animals to and from the show circuit, he knew her skills with livestock and her work habits. Before long Bob and Donna were married. Doug revealed later that he had guessed why Donna asked him for the chance to prove herself – so she could get Bob to notice her.

Donna was enthusiastic and popular with Doug's customers. Thanks to **word-of-mouth** advertising, the trucking firm soon incorporated and Doug learned the value of having employees own part of the business.

Notes from the Case Study

1. New employees must be carefully selected.
2. New employees must have **training** and direction.
3. Public relations are important.
4. Bob had been trained as an apprentice without any formal thought about training.
5. Knowledge of the business is valuable; Bob was a farmer.
6. A personal stake in the business' success is a great **incentive.**
7. Human relations are important.

LETTING GO OF SOME OF THE STRINGS

One thing that is often difficult for the beginning entrepreneur is delegating to another person some of the responsibility for operations. In the beginning most entrepreneurs have had to be the whole operation and do every job. The feeling that business success depends solely on the owner is difficult for one to relinquish.

Hiring that first employee and giving responsibility to that person is often an unnecessarily threatening experience. Unless the entrepreneur has had experience with another business, the task of hiring employees can be somewhat overwhelming.

Recruiting Employees

Where do you begin when hiring employees? First you need to do some homework – write a **job description**. (Figure 18-1 is a sample of how Doug might have written his.) Decide exactly what it is you want the employee to do. Few things can be more daunting to a new employee than to be expected to do a job for which he or she has not been trained. It is even more stressful if the employee has not been told that the task has to be performed.

EMPLOYMENT OPPORTUNITY

JOB TITLE: Truck Driver's Assistant

EMPLOYER: Hamline Trucking

LOCATION: Lacona, Iowa

QUALIFICATIONS: The successful candidate should have the following qualifications:

- Valid chauffeur's license
- Bondable
- Knowledge of and experience with livestock
- Knowledge of and experience with grain handling
- Knowledge of truck maintenance
- Ability to make simple repairs
- Flexibility in scheduling needed to travel to distant markets
- Flexibility in working hours
- Ability to write sales tickets
- Ability to compute bushels from weight tickets
- Ability to operate a truck scales
- Ability to prepare trucks for the hauling job
- Ability to tarp a load
- Ability to arrange weight distribution

Figure 18-1 Job description for a truck driver's assistant

Write a job description. It helps clarify which skills you want the new employee to be able to perform, and it enables prospective applicants to evaluate their interest in the job. A job description should convey to the applicants the tasks and skills required by the job. Your description may highlight just the priority skills, since some minor skills are learned on the job for any position.

What sources should you consider when recruiting applicants? The following list suggests some sources of possible contacts with prospective applicants:

1. State employment offices
2. Private employment agencies
3. Newspapers
4. Community schools
5. College or university placement offices
6. Cooperative education programs
7. Personal observation
8. Referrals from friends or others

You will have many contacts in the course of your everyday activities and encounter people who impress you with their personality, disposition, helpfulness, energy, or drive. Perhaps one of these might provide you with the type of employee who would be great for your business. Take time to become better acquainted with the individual and confirm your possible interest.

I recall one such incident that almost took me away from my job, and would have, had the location suited me. I helped my good friend Carl, move and he asked me to stop by his new office and meet his boss. It was hot and I was in grubby shorts and a T-shirt when we stopped by the office. Carl and I joked a lot and had been known to pull practical jokes with each other, so it was a very relaxed atmosphere. Suddenly I realized I was being interviewed, and not having just a polite, get-acquainted chat! Carl knew his boss was interested in talking with me and he set me up!

Screening Applicants

The first step in the screening process is to ask applicants to complete an **application** form. This application enables the employer to start screening applicants by evaluating their qualifications. However, you must be careful to not ask for information prohibited by law such as race, religion, and similar personal information not relating to the job.

Remember, each business and its needs are different and your application may need a specific skills sections. Figure 18-2 is suggested only as *a general example and not as a recommended form.* It would fail to obtain the important information you need, if like Doug, you need a person with specific livestock and grain experience and skills. Make sure you include that information in the job listing.

A formal application blank gives you uniform information about all the applicants. Your memory may be terrific, but most of us cannot retain all of these details, especially if more than 100 people apply for your job listing.

Your application blank should reflect the special aspects of your business; for example, if you want your employees to be active in trade associations you may want to ask what organizations they belong to. If you want community- and service-minded people, ask about their community involvement.

The second step in the screening process is reading the applications. The applications that meet the "must have" qualifications can be screened more closely for other important items. The people who match most closely may then be called for **interviews**. Some homework is required to prepare for these interviews.

Preparing for the interviews is the third step in the process. Interviews are stressful for the applicants as well as for the you, the interviewer. Anything you can do to ease stress enables you to evaluate the real person. I recall one interview during which I was put at ease in the simplest manner: the interviewer came out from behind his desk to greet me and we sat at a table at the side of his office. I enjoyed working for this man until his retirement.

APPLICATION FOR EMPLOYMENT AT THE X Y Z COMPANY

PERSONAL

Name _____ Social Security # _____

Address _____ Telephone # _____

_____ Date of Birth _____

EDUCATIONAL BACKGROUND

	Schools Attended	Dates	Degrees Awarded
1.			
2.			
3.			

(other training – technical, trade, business, military)

EMPLOYMENT HISTORY *(most recent first)*

	Name/Address	Dates	Salary	Duties	Reason for Leaving
1.					
2.					
3.					

REFERENCES

Name three persons we may contact who are familiar with your qualifications.

	Name	Address/Phone Number	Relationship
1.			
2.			
3.			

Include comments or special qualifications on the back of this form.

Date _____ Signature _____

Figure 18-2 Sample employment application

Prepare the questions in advance that you wish to ask. Don't hesitate to make notes during the interview and immediately afterwards. However, if note-taking bothers the applicant, wait until after the interview. Your goal is to choose the best possible employee, not cause stress.

The fourth step in the process is the interview. If possible, be thoughtful of the applicant and try to schedule the interview at a convenient time for both of you. Begin the interview at the scheduled time and have phone calls held until after the interview. Put the applicant at ease by asking nonthreatening questions about family, hobbies, or topics of current interest, or simply invite the applicant to talk about him or herself. Encourage the applicant to ask questions about the job or your company. The kinds of questions asked may give clues to a potential employee's interests and attitudes.

For example, one employer has his own personal checklist which he completes after each interview in an attempt to improve the people skills of his employees. Among the things he notes are the following:

1. Was this applicant sensitive to others?
2. Was this applicant easy to talk to?
3. Was this applicant comfortable in the interview?
4. Did this applicant have an aura of self-worth?
5. Did this applicant have the ability to keep feelings under control?
6. Did this applicant seem to be a caring person?
7. Did this applicant have a general air of trust?

The fifth step is making the selection. Sometimes an immediate hiring is delayed for some reason. If this occurs, keep the applicants informed as to the time and other pertinent information. When the final selection has been made and the new employee has accepted the job, the final step occurs: notify the applicants in writing of the hiring. Perhaps a "thank-you-for-your-interest" note would be appropriate. For the top candidates not hired you might want to suggest contacting them when you need or are able to add additional people to your staff.

INSURING THAT THINGS ARE DONE YOUR WAY

Training Employees

Orientation and training are two ways you can prepare new employees for their responsibilities. Orientation and training are two different aspects of this task. Doing this task well ensures that new employees know your preferred procedures.

Orientation is the process of familiarization with the working environment. Training is the instruction geared to making employees skilled or proficient in their assigned tasks in your workplace.

When your business is small and you hire your first employees, you will probably conduct the training yourself. As your business grows you may delegate the training to some member of your staff. Whichever is the case, instruction on how your company wants specific tasks done is important to the company and its employees.

Supervising Employees

Supervision, not "snoopervision," is recommend. Proper supervision insures a united team effort, not an **adversarial relationship**. View supervision as a helping activity, not an activity that threatens. New employees will welcome such help as they learn the company routines. Describing supervision depends on the nature of the business. For example, in a small assembly line operation the supervisor must ensure that each assembly position has a capable person doing the work. The supervisor must also see that the necessary parts and tools are at the workstations as needed. For example – in a small repair shop the supervisor assigns the mechanics to the repair jobs, completes the repair orders, meets with the customers, and performs similar tasks.

Delegating responsibilities to others makes time available to the entrepreneur for the task of guiding the growth of the company. When selecting a person to manage or supervise the other employees you must consider questions like the following:

1. Does this person have excellent people skills?
2. Does this person have experience in your industry?
3. Can this person motivate others?
4. Can this person correct problems fairly without antagonizing the corrected parties?
5. Can this person take initiative to get things done?
6. Can this person work without prompting?
7. Does this person have planning skills?
8. Does this person have the ability to anticipate needs?
9. Can this person get to the root of a problem and keep it from getting out of hand?
10. Does this person have the flexibility to handle the sudden absence of a worker?
11. Will this person know the workers well enough to be able to develop their potential?

Developing Employee Potential

Developing the potential of one's employees is a rewarding activity from two aspects. First, the employee who develops high potential probably brings more to the business from the financial standpoint. Secondly, developing employee potential brings satisfaction to the employer because he or she helped employees improve their skills and status.

On-site training, released time, and paying tuition for taking job-related courses and workshops are some of the ways you can help employees upgrade their knowledge and skills.

Always remember – helping your employees improve their situations, even if it means losing them to better paying jobs – pays off in the long run. Sometimes this payoff is the personal satisfaction of having done the right thing. I have worked for a number of bosses and the ones I recommended to others were those who helped me advance. One in

particular said, "I would rather have employees I know I'll lose one day because my business will not be able to give them the pay necessary to reward and keep them. While they are here they help my business prosper. Anyway, I enjoy seeing them succeed."

Communications

After your responsibilities have been shared with others, you need to maintain knowledge and overall control. The key to this control is communication. Methods that work include in-house communication, staff meetings, frequent stops in the shop, and an open-door policy.

Every business needs some system of reporting to help the employees keep up with the numbers and activities. Staff meetings on a regular basis can help bring up new trends, review progress, explore new growth possibilities, and solve mutual problems. Most importantly, staff meetings should keep everyone up-to-date. Figure 18-3 shows a sample agenda for a staff meeting.

Agenda for 8/29/XX

Minutes approval	Donna
Treasurer's report	Henry
Sales report	Joan
Pending contracts	Henry
Progress on the Model 95-15 retooling	Howard
Report from the Zoning Commission	Jill
Report from the Company Picnic committee	Josh
Coming events	Bob
Question time	All
Adjournment	

Figure 18-3 Sample staff meeting agenda

Some type of formal or informal company newsletter can also keep everyone informed of news and events within the company. Electronic mail sometimes serves to inform those on the computer network.

In small companies communication is usually as informal as a quick, open-door word or talk as the boss goes through the shop. As companies grow these communication systems need to grow with the company. The decreasing amount of time the boss can devote to each employee makes more complex communication a necessity.

REWARDING EXCELLENCE

Developing an Incentive Program

Good Work!

Employing and training the top-notch people your enterprise needs is the best way to succeed. When these people have helped your business grow and prosper, some means of rewarding them is needed. Good incentive programs are deserved rewards; good incentive programs motivate employees.

What are the elements of a good incentive plan? Consider the following elements when developing your plan:

1. Plan should be tied to measurable results.
2. Results should improve the bottom line.
3. Improve the product and, indirectly, the bottom line.
4. Measurable results should be above a previously set standard.
5. Plan must be seen as fair by all employees.
6. Plan must be affordable to the company.
7. Company must reach the profitability stage before the plan is instituted.

Allowing Employees to Own Part of the Business

One of the most effective incentive plans is the opportunity for employees to become part owners of the business. Then it becomes a **proprietary,** or ownership, interest in the well-being of the company. The first step in implementing such a plan is the formation of a corporation and the issuing of stock shares. Appendix B includes a checklist for incorporation. Incentives are distributed as **shares of stock** or the privilege of purchasing shares at a favorable price.

Care must be exercised in preserving management control by having enough shares that the owner retains the majority of stock until the owner wishes to sell or retire.

One small company was perpetuated in this manner by the owner who had no family. Each Christmas Eve he gave shares to his longtime employees so at the final Christmas before his retirement, the employees owned the majority of the company! In his last years he prepared them for management by forming all the necessary corporate officers and directors while he remained as president.

ADDITIONAL READINGS

1. Abrams, R. M. *The Successful Business Plan: Secrets and Strategies.* Oasis Press, 1991. pp. 137-145.
2. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 271-282.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Plan an agenda for a staff meeting for Doug's company.
2. Suggest items to include in his company's newsletter.

Activities to Aid Decision Making

1. Do a library search to learn the federal, state, and local laws or ordinances that apply to your business.
2. Design an employment application for your business.

Questions to Increase Your Understanding of the Text

1. Why is hiring the first employee threatening?
2. What are suitable ways to recruit employees?
3. What is the recommended first step in the hiring process?
4. Why is the use of an application form recommended?
5. What is the first rule in interviewing?
6. What is the difference between orientation and training?
7. Why is communication important to a business?

Questions to Aid Decision Making

1. Will I need employees this year?
2. What are the job descriptions in my business?
3. When I have employees, which incentive plan should I develop?

CHAPTER 19

What Risks Are There?

CHAPTER GOALS

- To identify the four risk management strategies.
- To identify pure and speculative risks.
- To define the concept of insurance.

KEY CONCEPTS

Coverage – The specific perils insured against.

Deductible – The amount the insured pays in case of a loss.

Endorsement – A special clause added to an insurance policy to cover certain perils.

Exclusions – Things excluded from the coverage.

Homeowners – An insurance policy to protect private homeowners.

Insurance – The risk of loss is assumed by the insurance company for a premium.

Liability insurance – Insurance against any liability arising from given activity.

Perils – Risks covered by the insurance policy.

Policy – Written details and conditions of purchased insurance.

Premium – Money paid for an insurance policy.

Property insurance – Insurance on property to protect from fire loss and similar items.

Pure risk – Insurable risk such as a fire or tornado.

Risk – Chance of misfortune, such as loss of your capital.

Risk avoidance – Avoiding the activities that cause risk.

Risk management – Selecting a risk option alternative.

Risk reduction – Using training or other methods to reduce risk.

Risk retention – Carrying the risk yourself instead of purchasing insurance.

Risk transfer – Purchasing insurance so the insurance company carries the risk.

Speculative risk – Risk of loss you accept when you invest money in your business.

CASE STUDIES

A Dead Jogger Kills a Business

A patron of a local bar left the premises, got into an automobile, and drove away. A few blocks away a jogger, out for his conditioning run, was jogging along the shoulder of the highway. The drunken driver veered onto the shoulder and struck the jogger.

As a result the jogger died. Both the driver and the bar were sued. The bar that supplied the driver with alcohol was found liable and the resulting judgment bankrupted the business.

The Case of a Broken Tooth

This author was at a meeting where Dick's father supplied free caramel corn samples to increase Dick's sales by acquainting potential customers with the product. The corn was delicious, but while eating it I broke a molar on an unpopped kernel.

The next day I called to mention the incident to Dick's father. He said a screening process was used to remove the unpopped kernels, but unfortunately it didn't always remove all of them. Earlier, when Dick and his father had their annual insurance review with their agent, the agent had suggested they purchase a policy **endorsement** to cover the risk of such an event. Consequently, their insurance paid my dental bill to repair my molar. Dick gained another loyal customer!

Kara Learns That Experience Is a Dear Teacher

Kara came back from deployment with her National Guard unit and found that her employer was no longer in business. She was a vehicle repair specialist in a transportation unit. Since no one in her city had openings for auto mechanics, she enrolled in a technical school to continue her auto air-conditioning studies and complete her certification. With the small savings she had accumulated Kara decided to start her own business.

During the time she was taking technical school classes, Kara did her market research. She used the facilities of her local library and SCORE chapter. With her only competition in the city coming from auto dealerships whose hourly rate charges started at $37.50 per hour, she thought there was a good opportunity for a profitable start.

She had inherited her grandparents' home when her grandmother died. The detached, two-car garage and workshop provided adequate space for her young business. Gradually she built up a good business volume.

Unfortunately, an electrical short started a fire which destroyed the building, equipment, tools, and a car she was currently repairing. When she filed her claim under her **homeowner's** policy she found, much to her dismay, that conducting a business on the premises had violated the insurance **policy** she had purchased. The loss of her customer's car was denied also.

The Yard Sale Accident

Four families took turns hosting their annual garage sale. One year a potential customer cut himself so severely it took several stitches at the local emergency room to close the wound. In this case the homeowner's policy paid the claim because the garage sale was considered incidental to the occupancy of the residence.

Notes from the Case Studies

1. An **insurance** policy is a binding legal contract having standard policy provisions, conditions, and limitations (or **exclusions**).
2. When a business use is made of your home, vehicle, or personal property, consult your insurance agent immediately.
3. Increasing exposure may require rewriting the policy at a higher **premium** due to the business pursuit.
4. Insurance can provide for insurable risks.
5. Even the smallest businesses need insurance.
6. Review your insurance policies annually and raise questions with your agent concerning points you do not understand.

THE IDEA OF RISK

Beware of Risk Pitfalls

Courts sometimes have to determine what constitutes a business pursuit. In one case a semi-retired man did odd jobs for friends and neighbors. Unfortunately, he was injured while using a sledge hammer during the demolition of a building. Consequently, he made a claim under a homeowner's policy. The insurance company denied the claim on the basis that it was a business activity. This claimant sued and won in the lower court, but the insurance company appealed. The appellate court then ruled that this activity was neither temporary nor casual, and because it was a regular activity for pay, it was a business activity.

Risk is universal. Because starting a business creates risk, the entrepreneur needs to consider risk management. Every time we step outside our doors we risk injury and a large number of accidents happen in the home. Over 13 million home-based businesses exist today. Consequently, the budding entrepreneur must be aware that the coverage in homeowner and automobile policies excludes business risks.

Entrepreneurs are risk takers taking calculated risks, they are not wild gamblers. They manage some risks by buying insurance and transferring the risk to others for the premium charge. Insurance is one management technique. The purpose of this chapter on risk is to think of insurance as a **risk management** tool.

Let's look at some of the causes of business failures. We said that underfunding or cash flow problems cause many business failures. Others fail for the following reasons:

1. No provision for unexpected events such as a fire or windstorm damage
2. Poor market evaluation
3. Poor planning
4. Underestimation of costs
5. Failure to specify payment terms
6. Overly optimistic sales estimates
7. Dishonesty
8. Improper pricing of services or products

There are four risk management strategies: **risk avoidance**, **risk reduction**, **risk retention**, and **risk transfer**. Each of these strategies are important, to a greater or lesser degree, to an entrepreneur.

RISK AVOIDANCE

Some risks can be avoided. Not offering a delivery service could avoid the risk of vehicle accidents in the delivery process. However, if your competitors offer such a service you may be limiting your potential customer base. Some risk avoidance can be the result of good business decisions; however, not all risks can be avoided.

RISK REDUCTION

Some business risks can be reduced; for example, your delivery drivers can be carefully chosen as safe drivers and then further instructed in safety. Preplanning and instruction can also reduce risk when the worst happens – i.e., an accident.

RISK RETENTION

Risk retention is a fact of life for any business. In most cases, a certain percentage of the risk is the responsibility of the business. The business may decide to retain the risk and lower insurance costs. In addition, some policies permit a business to accept a larger **deductible**, which is risk retention.

RISK TRANSFER

Risk is transferred by purchasing an insurance contract, or policy, for a premium. For a known premium payment the unknown cost of the risk is transferred to an insurance company. Purchasing insurance provides a budgeted amount to work into the cash flow of the business. For this fixed cost the business owner avoids an unknown and possibly ruinous cost.

Types of Risks

The two types of risk are speculative risk and pure risk. **Speculative risk** occurs when you invest your money in a business venture. This type of risk is also illustrated by investing in the stock market, or any other speculative investment.

Pure risk, on the other hand, is insurable. Fire or windstorms are examples of pure risk. Risk management is the process of identifying the risks and deciding which risk option to apply. Insurance companies research the likelihood of a given event and base their rates accordingly to pay claims, overhead costs, and return a profit to their shareholders.

INSURANCE COVERAGE

Selecting Insurance Coverage

The major categories of insurance an entrepreneur needs to consider are life, health, liability, and property insurance. We will discuss each briefly and then recommend the SBA insurance checklist for a detailed analysis of your insurance needs.

LIFE INSURANCE

Life insurance is purchased in the event of a business owner's untimely death. The policy face amount is payable upon death to the named beneficiary. Such insurance can prevent the unwanted sale of the business and provide for the perpetuation of the family business or partnership.

HEALTH INSURANCE

Health insurance costs are a major concern today for both employers and employees. Health care benefits are also a concern for the beginning entrepreneur as the change is made from employee to business owner.

LIABILITY INSURANCE

The case studies illustrate three businesses, two without adequate liability insurance. Any accident that results from improper management of a building, its premises, ownership or use of vehicles, and similar events is the responsibility of the owners. The checklist beginning on the following page suggests items to discuss with your insurance agent.

PROPERTY INSURANCE

Property insurance protects business property in the event of a loss due to a named peril, such as a fire or windstorm. Again, use the checklist and talk to your insurance agent.

OTHER INSURANCE

Many different kinds of insurance **coverage** are available for a premium. Most businesses manage risk by balancing their security with the cost of premiums for protection from such losses. Study the following checklist of essential and desirable coverage.

The Insurance Checklist

This checklist is adapted from the *SBA Management Aids*, Number 2.018, "Insurance Checklist for Small Business," by Mark R. Greene, University of Georgia.

ESSENTIAL COVERAGE

Four types of coverage are considered essential: fire insurance, liability insurance, automobile insurance, and worker's compensation insurance.

FIRE INSURANCE

If you have taken any of the following needed actions, place a check mark before the number.

____ 1. You can add other perils – such as windstorm, hail, smoke, vandalism, and malicious mischief – to your basic fire insurance at a relatively small additional cost.

____ 2. If you need comprehensive coverage your best buy may be one of the all-risk contracts which offer the broadest available protection for the money.

____ 3. The insurance company may indemnify you – that is, compensate you for your losses in any one of several ways. It may pay actual cash value at time of loss; it may repair or replace the property with material of like kind and quality; or it may take all the property at the agreed or appraised value and reimburse you for your loss.

____ 4. You can insure property you don't own if you have an insurable – a financial interest – in the property when a loss occurs, but not necessarily at the time the insurance contract is made. For instance, a repair shop or dry-cleaning plant may carry insurance on the customers' property in the shop, or you may hold a mortgage on a building although you don't own it.

____ 5. When you sell property, you cannot assign the insurance policy along with the property unless you have permission from the insurance company.

____ 6. Even if you have several policies on your property, you can still collect only the amount of your actual cash loss. All the insurers share the payments proportionally. For example, suppose that you are carrying two policies – one for $20,000 and one for $30,000 – on a $40,000 building, and a fire causes damage to the building amounting to $12,000. The $20,000 policy will pay $4,800; that is –

$$\frac{20{,}000}{50{,}000} \text{ or } \frac{2}{5} \text{ of } \$12{,}000.$$

The $30,000 policy will pay $7,200; that is –

$$\frac{30{,}000}{50{,}000} \text{ or } \frac{3}{5} \text{ of } \$12{,}000.$$

____ 7. Special protection other than the standard fire insurance policy is needed to cover the loss by fire of accounts, bills, currency, deeds, evidence of debt, and money and securities.

____ 8. If an insured building is vacant for more than 60 consecutive days, coverage is suspended unless you have a special endorsement to your policy canceling this provision.

____ 9. If, either before or after a loss, you conceal or misrepresent to the insurer any material fact or circumstance concerning your insurance or the interest of the insured, the policy may be voided.

____ 10. If you increase the hazard of a fire, the insurance company may suspend your coverage even for losses not originating from the increased hazard. (An example of such a hazard might be renting part of your building to a dry-cleaning plant.)

____ 11. After a loss, you must use all reasonable means to protect the property from further loss or run the risk of having your coverage canceled.

____ 12. To recover your loss, you must furnish within 60 days (unless an extension is granted by the insurance company) a complete inventory of the damaged, destroyed, and undamaged property showing in detail the quantities, costs, actual cash value, and amount of loss claimed.

____ 13. If you and the insurer disagree on the amount of the loss, the question may be resolved through special appraisal procedures provided for in the fire insurance policy.

____ 14. You may cancel your policy without notice at any time and get part of the premium returned. The insurance company also may cancel at any time with a five-day written notice to you.

____ 15. By accepting a coinsurance clause in your policy, you get a substantial reduction in premiums. A coinsurance clause states that you must carry insurance equal to 80 or 90 percent of the value of the insured property. If you carry less than this, you cannot collect the full amount of your loss, even if the loss itself is small. What percent of your loss you can collect depends on what percent of the full value of the property you have insured.

____ 16. If your loss is caused by someone else's negligence, the insurer has the right to sue this negligent third party for the amount it has paid you under the policy. This is known as the insurer's right of subrogation. However, the insurer will usually waive this right upon your request. For example, if you have leased your insured building to someone and have waived your right to recover from the tenant for any insured damages to your property, you should have your agent request the insurer to waive the subrogation clause in the fire policy on your leased building.

____ 17. A building under construction can be insured for fire, lightning, extended coverage, vandalism, and malicious mischief.

LIABILITY INSURANCE

_____ 1. Legal liability limits of $1 million are no longer considered high or unreasonable even for small businesses.

_____ 2. Most liability policies require you to notify the insurer immediately after an incident on your property that might cause a future claim. This holds true no matter how unimportant it may seem at the time it happens.

_____ 3. Most liability policies, in addition to bodily injuries, may now cover personal injuries (liable, slander, and so on) if these are specifically insured.

_____ 4. Under certain conditions, your business may be subject to damage claims even from trespassers.

_____ 5. You may be legally liable for damages even in cases where you used "reasonable care."

_____ 6. Even if the suit against you is false or fraudulent, the liability insurer pays court costs, legal fees, and interest on judgments in addition to the liability judgments.

_____ 7. You may be legally liable for the acts of others under contracts you have signed with them. This liability is insurable.

_____ 8. In some cases you may be held liable for fire loss to the property of others in your care. Yet, this property would normally not be covered by your fire or general liability insurance. This risk can be covered by fire legal liability insurance or through requesting subrogation waivers from insurers of owners of the property.

AUTOMOBILE INSURANCE

_____ 1. When an employee or a subcontractor uses a car on your behalf, you can be legally liable even though you don't own the car or truck.

_____ 2. Five or more automobiles or motorcycles under one ownership and operated as a fleet for business purposes can generally be insured under a low-cost fleet policy against both material damage to your vehicle and liability to others for property damage or personal injury.

_____ 3. You can often get deductibles of almost any amount – say $250 or $500 – and thereby reduce your premiums.

_____ 4. Automobile medical-payment insurance pays for medical claims, including your own, arising from automobile accidents regardless of the question of negligence.

_____ 5. In most states, you must carry liability insurance or be prepared to provide other proof (surety bond) of financial responsibility when you are involved in an accident.

_____ 6. You can purchase uninsured-motorist protection to cover your own bodily injury claims from someone who has no insurance.

_____ 7. Personal property stored in an automobile and not attached to it (for example, merchandise being delivered) is not covered under an automobile policy.

WORKER'S COMPENSATION

____ 1. Federal and common law requires that an employer do the following: provide employees a safe place to work, hire competent fellow employees, provide safe tools, and warn employees of an existing danger.

____ 2. If the employer fails to provide the above, the employer is liable for damage suits brought by an employee and possible fines or prosecution.

____ 3. State law determines the level or type of benefits payable under worker's compensation policies.

____ 4. Not all employees are covered by worker's compensation laws. The exemptions are determined by state law; therefore, they vary from state to state.

____ 5. In nearly all states you are now legally *required* to cover your workers under worker's compensation.

____ 6. You can save money on worker's compensation insurance by seeing that your employees are properly classified.

____ 7. Rates for worker's compensation insurance vary from 0.1 percent of the payroll for "safe" occupations, to 25 percent or more of the payroll for very hazardous occupations.

____ 8. Most employers in most states can reduce their worker's compensation premium cost by reducing their accident rates below the average. They do this by using safety and loss-prevention measures.

DESIRABLE COVERAGE

Some types of insurance coverage, although not absolutely essential, add greatly to the security of your business. This coverage includes business interruption insurance, crime insurance, glass insurance, and rent insurance.

BUSINESS INTERRUPTION INSURANCE

____ 1. You can purchase insurance to cover fixed expenses which continue if a fire shuts down your business – for example, salaries to key employees, taxes, interest, depreciation, and utilities – as well as lost profits.

____ 2. Under properly written contingent business interruption insurance, you can also collect if fire or another peril closes down the business of a supplier or customer and consequently interrupts your business.

____ 3. The business interruption insurance policy provides payments for the amounts spent to hasten the reopening of your business after a fire or other insured peril.

____ 4. If an insured peril seriously disrupts your business without actually closing it, you can get coverage for the extra expenses you incur.

_____ 5. When the policy is properly endorsed, you can get business interruption insurance to indemnify you if your operations are suspended due to failure or interruption to the supply of power, light, heat, gas, or water furnished by a public utility company.

CRIME INSURANCE

_____ 1. Burglary insurance excludes such property as accounts, fur articles in a showcase window, and manuscripts.

_____ 2. Coverage is granted under burglary insurance only if there are visible marks of the burglar's forced entry.

_____ 3. Burglary insurance can be written to cover – in addition to money in a safe – inventoried merchandise and damage incurred in the course of the burglary.

_____ 4. Robbery insurance protects you from loss of property, money, and securities by force, trickery, or threat of violence on or off your premises.

_____ 5. A comprehensive crime policy written just for small business owners is available. In addition to burglary and robbery, it covers other types of loss by theft, destruction, and disappearance of money and securities. It also covers thefts by your employees.

_____ 6. If you are in a high-risk area and cannot get insurance through normal channels without paying excessive rates, you may be able to get help through the federal crime insurance plan. Your agent or state insurance commissioner can tell you where to get information about these plans.

GLASS INSURANCE

_____ 1. You can purchase a special glass insurance policy that covers all risks to plate glass windows, glass signs, motion-picture screens, glass brick, glass doors, showcases, countertops, and insulated glass panels.

_____ 2. The glass insurance policy covers not only the glass itself, but also its lettering and ornamentation (if these are specifically insured), and the costs of temporary plates or boarding up when necessary.

_____ 3. After the glass has been replaced, full coverage is continued without any additional premium for the period covered.

RENT INSURANCE

_____ 1. You can buy rent insurance that pays your rent if the property you lease becomes unusable due to fire or other insured perils and if your lease requires continued payments in such a situation.

_____ 2. If you own property and lease it to others, you can insure against loss if the lease is canceled due to fire and you have to rent the property again at a reduced rental.

EMPLOYEE BENEFIT COVERAGE

Insurance coverage which can be used to provide employee benefits includes group life insurance, group health insurance, disability insurance, and retirement income. Key-employee insurance protects the company against financial loss caused by the death of a valuable employee or partner.

GROUP LIFE INSURANCE

____ 1. If you pay group insurance premiums and cover all employees up to $50,000, the cost to you is deductible for federal income tax purposes, and yet the value of the benefit is not taxable income to your employees.

____ 2. Most insurers will provide group coverage at low rates even if there are 10 or fewer employees in your group.

____ 3. If the employees pay part of the cost of the group insurance, state laws require that 75 percent of them must elect coverage for the plan to qualify as group insurance.

____ 4. Group plans permit an employee leaving the company to convert group insurance coverage to a private plan, at the rate for his/her age, without a medical exam, within 30 days after leaving the job.

GROUP HEALTH INSURANCE

____ 1. Group health insurance costs much less and provides more generous benefits for the worker than individual contracts do.

____ 2. If you pay the entire cost, individual employees cannot be dropped from a group plan unless the entire group policy is canceled.

____ 3. Generous programs of employee benefits, such as group health insurance, tend to reduce labor turnover.

DISABILITY INSURANCE

____ 1. Worker's compensation insurance pays an employee only for time lost due to work injuries and work-related sickness – not for time lost due to disabilities incurred off the job. But you can purchase, at a low premium, insurance to replace the lost income of workers who suffer short-term or long-term disability not related to work.

____ 2. You can get coverage which provides employees with an income for life in case of permanent disability resulting from work-related sickness or accident.

RETIREMENT INCOME

____ 1. If you are self-employed, you can get an income tax deduction for retirement funds used for you and your employees through plans of insurance or annuities approved for use under the Employees Retirement Income Security Act of 1974 (ERISA).

____ 2. Annuity contracts may provide for variable payments in the hope of giving the annuitants some protection against the effects of inflation. Whether fixed or variable, an annuity provides retirement income that is guaranteed for life.

KEY-EMPLOYEE INSURANCE

____ 1. One of the most serious setbacks that can happen to a small company is the loss of a key employee. But your key employee can be insured with life insurance and disability insurance owned by and payable to your company.

____ 2. Proceeds of a key-employee policy are not subject to income tax, but premiums are not a deductible business expense.

____ 3. The cash value of key-employee insurance which accumulates as an asset of the business can be borrowed against. The interest and dividends are not subject to income tax as long as the policy remains in force.

ORGANIZING YOUR INSURANCE PROGRAM

A sound insurance protection plan is just as important to the success of your business as good financing, marketing, personnel management, or any other business function. And like the other functions, good risk and insurance management is not achieved by accident, but by organization and planning. A lifetime of work and dreams can be lost in a few minutes if your insurance program does not include certain elements. To make sure you are covered, take action in the following four distinct ways:

1. Recognize the various ways you can suffer loss.
2. Follow the guides for buying insurance economically.
3. Organize your insurance management program.
4. Get professional advice.

Recognize the Risks

The first step toward good protection is to recognize the risks you face and make up your mind to do something about them. Wishful thinking or an "it-can't-happen-to-me" attitude won't lessen or remove the possibility that a ruinous misfortune may strike your business.

Some businesses need coverage not mentioned in the checklist. For example, if you use costly professional tools or equipment in your business, you may need special insurance covering loss or damage to the equipment and/or business interruption resulting from an inability to use the equipment.

Study Insurance Costs

Before you purchase insurance, investigate the methods by which you can reduce the costs of your coverage. Be sure to cover the following points:

1. Decide what perils to insure against and how much loss you might suffer from each.
2. Cover your largest loss exposure first.
3. Use as high a deductible as you can afford.
4. Avoid duplication in insurance.
5. Buy in as large a unit as possible. Many of the "package policies" are very suitable for the types of small businesses they are designed to serve, and often they are the only way a small business can get really adequate protection.

6. Review your insurance program periodically to ensure that your coverage is adequate and your premiums are as low as possible while providing sound protection.

Have a Plan

To manage your insurance program for good coverage at the lowest possible cost, you need a definite plan that secures the objectives of your business. Following are some suggestions for good risk and insurance management:

1. State clearly what you expect insurance to do for your firm.
2. Select only one agent to handle your insurance. Having more than one may spread and weaken responsibility.
3. If an employee or partner is responsible for your insurance program, be sure he/she understands this responsibility.
4. Do everything possible to prevent losses and to keep those that do occur as low as possible.
5. Don't withhold from your insurance agent important information about your business and its exposure to loss. Treat your agent as a professional helper.
6. Don't try to save money by under-insuring or by not covering some perils which could cause loss, even though you think the probability of their occurring is very small. If the probability of loss is very small, the premium will also be small.
7. Keep complete records of your insurance policies, premiums paid, and loss recoveries. This information helps you get better coverage at lower costs in the future.
8. Have your property appraised periodically by independent appraisers. This keeps you informed of what your exposures are. Then you are better able to prove your actual losses if they occur.

Get Professional Advice about Your Insurance

Insurance is a complex and detailed subject. A professionally qualified agent, broker, or consultant can explain the options, recommend the right coverage, and help you avoid financial loss.

Selecting an Insurance Representative

Since we buy insurance for two reasons – protection and peace of mind – we should buy with care. The person who can help you most is the local insurance agent who knows your business and has the trust of his or her clients. Some people suggest that you be as careful in that selection as you are in the selection of a family doctor. In fact, the health of your business later on may depend on decisions you and your agent make in the beginning.

Your insurance agent may be one of two types: a direct writer who writes for one insurance company or an independent agent who writes insurance for several different companies.

ADDITIONAL READINGS

1. Abrams, R. M. *The Successful Business Plan: Secrets & Strategies.* Oasis Press, 1991. pp. 167-174.
2. Green, D. H. *Consumers in the Economy.* South-Western Publishing Co., 1992. pp. 301-317.
3. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 283-297.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Do a library search and look up the ratings, such as *Best's Reports* and others, for two or more insurance companies selling insurance in your state.
2. Interview an insurance agent and ask what types of insurance a small business should carry.

Activities to Aid Decision Making

1. Read and complete the checklist (SBA 2.018 *Insurance Checklist for Small Business*) as it pertains to your business.
2. Take the results of the checklist to two insurance agents and ask for competitive bids for the needed insurance.
3. Read your personal auto, homeowner's, and renter's policies and identify exclusions pertaining to "business pursuit."

Questions to Increase Your Understanding of the Text

1. Define risk.
2. What are common causes of business failure?
3. How can insurance increase the chances for survival of a young business?
4. Name the risk management strategies.
5. What are the insurance categories a business should consider essential?
6. How may insured losses be compensated?

7. What is the standard length of time allowed for the filing of an insurance claim?
8. What is coinsurance?
9. What is liability insurance?
10. What is crime insurance?
11. How should a small business owner organize the business' insurance?

Questions to Aid Decision Making

1. Which types of insurance should your business buy?
2. What will this insurance cost?
3. Should your business pay quarterly, semiannual, or annual premiums?
4. How large should your deductibles be?

CHAPTER 20

Managing Business Expansion

CHAPTER GOALS

- To identify methods of expansion.
- To identify signs of needed expansion.
- To introduce the idea of computer-assisted decisions.

KEY CONCEPTS

Expansion – Enlarging the business through various means.

Feasibility – Checks the possible profitability of a proposed decision.

Home-based – Operated from the home.

Operating capital – Funds used to maintain operations.

Sales tax permit – Permit to collect mandatory sales taxes.

Spreadsheet – Powerful computer program that can give quick answers to financial projections of varying conditions.

Support team – Those who lend support and aid to an entrepreneur.

Zoning ordinances – Laws restricting certain business locations.

CASE STUDIES

Jack's Service Proves Popular

Jack came home from his service in the Army and decided he was tired of someone else telling him what to do. He was looking for something that could provide him with both independence and a good living. One day his neighbor, Clarice, asked him if he would pick up water softener salt and load her water softener. He was glad to help her, but when she insisted on paying for his time and effort, Jack thought – maybe I can do this type of work for a living.

Jack had an old pickup truck and put a small advertisement in the local paper. Clarice told her elderly friends about how helpful Jack was. Soon he was buying his salt wholesale and servicing a number of homes. The business grew and Jack found that if he bought the salt in larger quantities his profit margin improved.

However, Jack's single-car garage was too small and he also had a jealous neighbor who was hinting that Jack was violating the **zoning ordinance** by running a business out of his home. Therefore, he had two problems to solve immediately. Up to this time his little business had grown well without any particular guidance. With his small investment and his own labor, Jack hadn't worried about business details. He did apply for a **sales tax permit** in order to resell the salt, but did not obtain any city permits or similar documents.

Jack asked for advice from another neighbor, Jim. He had retired from managing a large company in the city. During Jack's junior and senior years in high school, he had delivered Jim's newspaper, so they had known each other for quite some time. Jim had been observing Jack's progress in his current business and gladly offered advice and help. First, he helped Jack develop a business plan to examine the potential for business expansion.

Next, he helped Jack develop a loan application to obtain funds for expanding his business to a full-service, water-conditioning business. After researching the market, studying locations, and obtaining the loan (with Jim's investment and backing), J & J Water Services, Inc. held their grand opening. In the beginning, Jim and Jack's wife, Ruth, ran the showroom and office while Jack and a part-time employee handled the warehouse and deliveries. The business eventually expanded. When Jim left for Florida that year, Jack took over part of the showroom duties and made the employee full-time.

Henry Starts Out on His Own

Henry had worked for a major department store chain and decided to go into business for himself. Choosing a small shopping center, he set up a plant and hobby shop. As his **operating capital** grew from sales, he expanded the business by moving the partition back into the storage area and adding stock to the display area. His plan was to find out what items his customers would buy. As more funds became available, he increased his inventory and added more items to his shop.

He expanded those item lines which sold rapidly and well. In turn, any items that didn't do well were stocked in small amounts and selection. Informal questions provided insight to market trends and which items to add to inventory. Henry's experience in the department store business provided a good background for decision making as he became an entrepreneur. He spent his life savings with care and the inventory lines added to his little shop proved profitable. In the start-up phase his wife, a school teacher, helped in the store on Saturdays and provided a second income that helped defray living expenses.

Although Henry did not write a business plan, he certainly thought about it carefully and did his research before choosing his location and starting the business. His location in a mini-mall in a suburban city proved a popular shopping area and attracted several other young entrepreneurs.

Henry's son, Ron, was a high school student and became interested in computers. After learning to use a **spreadsheet** program, Ron talked with his father about the advantages of using business software in decision making. Soon Ron was helping the store computerize inventories, orders, and all other record keeping activities.

The mini-mall owner noted the increase in business and decided to double the rent at the start of the next year when leases were renewable. Henry and his fellow tenants discussed the situation and investigated other locations, traffic counts, rents, and the likelihood of maintaining current customers. Ron helped his father set up a spreadsheet and they forecast several possible results of a move to a new location. Based on the known facts from the start-up in the current location, and several possible projections of final profits, their best estimate was that, in the short run, the present location was still the most profitable. In addition, a move would put the store out of walking distance from their home. Henry decided to pay the doubled rent and avoid the move. He soon asked the landlord for additional space for his growing business.

Notes from the Case Studies

1. Jack had the entrepreneurial spirit.
2. Jack started a **home-based** business.
3. His initial investment was small.
4. Word-of-mouth advertising helped his business.
5. Jack sought advice when he needed it.
6. Jack researched the possible **expansion** and wrote a business plan.
7. With Jim's help, Jack's business grew nicely.
8. A **support team** is valuable to an entrepreneur.
9. Business experience helped Henry.
10. A spouse's support and second income is often important.
11. Henry did his market research.
12. Henry let his customers guide his expansion.
13. Henry used a computer program to research a possible move.
14. Henry used sales records to decide which merchandise lines to expand.

Knowing When to Expand

Knowing when to expand is an important managerial skill that few business managers master. What are the symptoms of a business that needs to expand? Perhaps a few thoughtful questions can help clarify the concept.

1. Has the business outgrown the space?
2. Have customers been asking for other items?
3. Will additional lines boost profits?
4. Are current personnel under-used?
5. Will expansion into the new line improve the competitive position?
6. Will the proposed expansion cash flow?
7. Will expansion draw more customers?
8. Does the business have under-used capital?
9. Does the business have under-used space?
10. Would expansion hinder operating capital?

Using the "What If" Technique

Many computer programs are available that let you play the "what if" game with a computer. Henry's son used a spreadsheet to examine the costs and returns of several different situations. The cost items and sales projections can be varied and used to forecast possible results. These programs can do many calculations in a very short time and are a valuable decision tool. Looking at the new costs involved in an expansion can let you see how sales will have to grow to retain and increase the current profit.

Different Ways to Expand

Case stories have already named several ways to expand informally. Among the different ways a business might expand are the following:

1. Stay open more hours.
2. Increase the number of merchandise lines.
3. Add more machines to production lines.
4. Add a second or third shift of workers in the plant.
5. Build a new plant.
6. Hire more sales people.
7. Adopt new technology and machines.
8. Subcontract some work.

Jack knew he needed help when it was time to change or expand his operations. Owners and managers need to know when to call on the wisdom and expertise of others.

For beginning entrepreneurs we recommend contacting the nearby SCORE chapter. Additional sources of aids are listed in Chapter 22.

Again, let us emphasize the need to update the business plan to check the **feasibility** of the expansion.

ADDITIONAL READINGS

1. Abrams, R. M. *The Successful Business Plan: Secrets & Strategies.* Oasis Press, 1991. pp. 32-39.
2. Anders, R. L. *Managing Small Businesses.* West, 1993. pp. 564-574.
3. Fry, F. L. *Entrepreneurship a Planning Approach.* West, 1993. pp. 288-295.
4. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 307-314.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Interview a manager or owner whose business has recently expanded. Ask how the decisions were made.
2. Observe businesses that have added merchandise lines or services and note how customers react.
3. Suggest items Jack could add to his water-conditioning business.
4. Practice the use of computer spreadsheets.

Activities to Aid Decision Making

1. List products or services you could add later to your business.
2. Identify items your competition sells.
3. Determine the cost of adding the items in activity 1 to your business.
4. Develop a computer spreadsheet to help in this decision making.

Questions to Increase Your Understanding of the Text

1. Name five ways a business can expand.
2. Why should the business plan be updated before expansion?
3. What are some indicators that expansion would be profitable?

Questions to Aid Decision Making

1. How much working capital is needed for the daily operation of your business?
2. What are the items your customers ask for?
3. Is your business ready to consider expansion?
4. Have you done the "what if's?"

CHAPTER 21

Legal Concerns for Your Business*

CHAPTER GOAL

- To introduce the legal aspects of a business venture.

KEY CONCEPTS

Accrue – Accumulate.

Americans with Disabilities Act – Act providing equal access and opportunity for all Americans.

Articles of incorporation – Written items describing the purpose and organization of the corporation.

Bylaws – Written guidelines for the operation of the organization.

Environmental Protection Act – Law to protect the environment.

Lien rights – Claim against assets of the company.

Occupational Health and Safety Act (OSHA) – Regulates the working conditions which employers provide their employees.

Ratify – Approve.

Shareholders – Ownership of a corporation based on investment.

Sheltered – Protected from personal liability.

Trust fund taxes – Withholding taxes collected from employee wages.

Uniform Commercial Code – Regulates sales between merchants.

Warranties – Sale of goods sometimes gives implied guarantees.

CASE STUDY

Dave and Dan Quit Their Jobs to Become Secure!

Dave and Dan both worked as supervisors for ABC Food Company for a number of years. During weekends and time off, they also performed construction jobs in their community, particularly, jobs involving electrical work. Dan also became very involved with computers and how they interact with home electrical applications. These part-time jobs became more numerous and eventually they began installing home security systems.

*By James R. Schrier, Firm of Reiling, Teder, Withered, and Rush

When ABC Food Company decided to move its operations to Mexico because of increased labor costs, Dan and Dave decided to stay in the community even though they were offered jobs with ABC Food Company in a southern state. Because their "side" job was going so well, it was only natural for Dan and Dave to devote their full attention to its operation. Accordingly, they formed Real Safe Security Company.

Notes from the Case Study

1. Many enterprises get their initial push from an unwanted transfer.
2. Many enterprises start as a sideline.
3. Many budding entrepreneurs need only the nudge.
4. There are legal concerns when a business starts up.
5. Supervisory skills from previous experience are helpful in a new venture.

ORGANIZING THE BUSINESS

An earlier chapter stated that any time a new business is formed, there are three ways it can be organized: a sole proprietorship, a partnership, or a corporation. This chapter looks at the legal requirements of each.

Sole Proprietorship

Sole proprietorship is established any time an individual operates any type of business. There are no formal requirements for operating this type of business; that is, no written documents are necessary. However, many states require that a certificate be filed with the County Recorder indicating the name under which the business will be operated. If, for example, Dan wishes to operate the company as a sole proprietor and hire Dave as one of his employees, the only document he needs to file is a certificate stating that his business name is Real Safe Security Company. There are situations, however, when two or more people can own an interest in certain assets; they each have the right to use those assets for their own purposes and each can still operate as a sole proprietor. Such joint ownership will not necessarily result in a partnership being formed.

Partnership

Any time two or more people become co-owners of a business for profit, a partnership is formed. Obviously, all the partners must agree to the formation of this partnership, since no one can become a member of the partnership without everyone's consent. However, no formal written documents are required to form a partnership. Furthermore, a partnership can be established simply by the acts of those people involved, regardless of whether they expressly agree that they are forming a partnership.

In the event no written partnership agreement is signed by the parties, the rights and liabilities of the partnership and the people involved are determined by state law. Most states have adopted the **Uniform Partnership Act** which governs the rights, liabilities, and duties of

each partner. The provisions of the Act determine how profits of the partnership are divided, how liabilities of the partners are determined, and how the partnership can be dissolved. It also provides that the partners can modify the terms of the partnership by express agreement. For example, the partners can divide the profits in any percentages they wish (e.g., 60/40, 70/30) even though the Act provides that partnership profits are, absent of an agreement, equally divided. In the previous example, if Dan is contributing more property, experience, and expertise to the partnership, he and Dave may decide that 60 percent of the profits go to Dan and 40 percent go to Dave. A like division could be made with any debts or liabilities.

Corporations

There are two basic types of corporations: C-corporations and S-corporations. An S-corporation is a special type of corporation which provides the benefits of limited liability and also allows for the income and losses of the corporation to pass on to the individuals, much like a partnership. If an S-corporation election is to be made, then strict guidelines must be followed on how and when to make the election. If it is anticipated that the business will incur operating losses in the early years of its existence, then it may be wise to elect S-corporation status in order to pass these losses on to the individual shareholders. It may be possible later, when the corporation has become profitable, to revoke the S-corporation election and become a C-corporation.

If a corporation is organized and an S-election is not made, then the corporation is automatically a "regular" or C-corporation. Especially with regard to small businesses, it is often advisable at the time the corporation is organized to specify that its stock will be issued as section 1244 stock. This provides special treatment for any losses that shareholders may incur in connection with the future disposition of their stock. If a proper 1244 election is made, then any tax loss incurred in the sale of stock is normally treated as an ordinary operating loss and not a capital loss.

One of the major advantages of organizing as a corporation is that in many cases the individuals can be **sheltered** from personal liability. The corporation is, in effect, an entity in and of itself and the individual officers, directors, and **shareholders** are generally not liable for any wrongdoing of the corporation.

It is very important when a corporation is formed that the value of any property transferred into the corporation be determined at that time. For example, if Dan has a pickup truck, tools, and a computer which he wants to transfer into the business, he and his accountant should determine the value of those assets and their tax basis for depreciation purposes at the time the corporation is formed.

When a corporation is formed, it is important that all the corporate formalities be observed at its inception and on a yearly basis. The **Articles of Incorporation** and the **Bylaws** should be properly prepared and accepted by initial meetings of shareholders and directors. Directors and officers should be immediately elected. An annual meeting of the shareholders and directors should be held and the minutes of these meetings maintained in the corporate minute book. It is not necessary that numerous meetings be held throughout the year, or that meetings be

held to approve every minor business decision. Rather, an annual meeting **ratifying** all the prior actions taken by the officers and directors is usually sufficient to satisfy the formal requirements of corporate existence. Also, most states require that annual reports be filed with the Secretary of State and an annual fee paid in order to keep the corporation in good standing. If the corporate formalities are not followed and maintained, the officers, directors, and shareholders may become personally liable for liability or wrongdoing of the corporation.

FINANCING

The key to borrowing money for any new business venture is to protect existing personal assets to the fullest extent possible. Dan and Dave both need to be aware that, if a lender is asking for a second mortgage on their house or a personal guarantee of business loans, then they have jeopardized personal and family assets.

Sole Proprietorship

Any time a sole proprietorship borrows money, the owner simply incurs the obligation in his or her individual capacity and uses the funds in the business venture. If Dan is the sole proprietor and borrows money, then Dave, as an employee, has no obligation to repay these funds even if the business fails.

Partnership

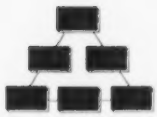
All partners are generally liable for any debt of the partnership. In other words, if Dan borrows money to be used by the partnership, then the lender can file suit against both Dan and Dave. Dave is liable for the repayment of that debt. If the lender then obtains a judgment against Dan and Dave, the lender may look to their **individual** assets to satisfy that obligation.

Corporation

If the corporation borrows money in its own name, then it is the only party responsible for repaying that debt. However, most lenders will not loan to new corporations without some assurance from the individuals involved that they will stand behind the obligation. Accordingly, many lenders ask that the officers, directors, and possibly the shareholders of the corporation sign a personal guarantee for the loan or co-sign the loan as an individual party. One should always be extremely careful when signing a personal guarantee. Such a document normally guarantees the repayment of all present and future debt incurred by the borrower – i.e., the corporation. Often five or ten years later, when the corporation is in severe financial difficulty, the lender will pull from its file this unlimited and continuous guarantee that the cosigners may have forgotten about. For example, Dave may leave the Real Safe Security Company to begin his own successful business. Years later, he discovers that the bank is requiring him to pay all of Real Safe's loan because he signed the original loan's personal guaranty.

MANAGEMENT AND OPERATIONS

Management Structure



In any sole proprietorship, the management and decision making is usually an easy task. The sole proprietor has all power and authority with regard to any business decisions. However, problems may arise during a divorce if the spouse of a sole proprietor claims that the business is an asset which should be divided between the parties.

Management and decision making become more complicated in a partnership setting. Unless the partners have agreed who is the managing partner and makes the day-to-day decisions, the business operation can bog down due to petty disputes. A **partnership agreement** can help prevent these problems (see sample provided in Appendix A). The operation of a partnership can also become difficult if one partner simply decides to walk away from the business; consequently, there must be a division of property.

Management and decision making are often more structured in a corporate setting. The shareholders elect directors who, in turn, elect officers of the corporation. The duties of these officers are structured such that each officer has his or her own responsibilities. Thus, there is little day-to-day conflict on how decisions should be made and who should make those decisions.

Purchases and Sales

When a business begins operations, it is no longer protected by many consumer protection laws. Rather, the business moves to the "other side of the fence" and is required to comply with such laws when dealing with its customers. Any time the new business deals with other businesses – whether it be providing them with goods or services, or purchasing goods or services from them – the transactions normally are governed by Article II of the **Uniform Commercial Code** as adopted by the respective state. This Uniform Code has strict provisions regarding sales between merchants. For example, any contract for the sale of goods, the price of which is in excess of $500, normally has to be in writing before it will be enforceable. Also, there are certain implied **warranties** that become associated with the sale of any goods unless the business specifically disclaims certain warranties. Furthermore, a business may be responsible for damage or loss associated with the sale of its goods, far in excess of the actual cost of these goods. For example, if Real Safe Security Company sells a defective security system to a home owner and the house is vandalized, Real Safe Security Company could be liable for all incidental and consequential damages caused thereby – that is, the loss of all the property or the value of the property which was vandalized. To prevent this, the business should have written contracts disclaiming any such liability and limiting its liability to the cost of the goods.

Another important consideration any time the business sells items or provides services on credit is the language used in the invoice statement or contract evidencing the credit sale. Normally, if there is no provision in a written document that the purchaser is required to pay interest if the

amount is not paid on time, then the business cannot compute interest. Unless a contract or invoice specifically states that attorney fees may be recovered in the event collection action is undertaken, a court normally will not award attorney fees to the business if they have to bring a lawsuit to collect on an account.

Licensing and Regulations

Most local governmental entities have special regulations or ordinances regarding certain types of businesses. For example, taxi services, shooting galleries, contractors, private patrols, food vendors, and similar businesses must have special permits for operating a business. When starting a new business, always check with the City Clerk's office for a list of ordinances which may be applicable. In addition, speak with the County Clerk or County Recorder regarding similar ordinances on a county-wide basis.

State laws and regulations also need to be considered any time a new business is formed. There are numerous laws governing employment practices. For example, generally, employees have to be paid at least bi-weekly; they must be paid at least the state minimum wage; and the employer cannot withhold from their wages money which the employee owes the employer unless the employee consents. In the event an employer is not able to pay employees, then state law often provides that penalties shall be assessed to the employer along with attorney fees. Furthermore, unpaid employees often have superior **lien rights** to the assets of the business.

Most states have occupational safety and health administrations which regulate the working conditions of any employer so that the employees' health and safety are safeguarded. Some of these regulations may be more stringent than Federal OSHA (**Occupational Health and Safety Act**) requirements.

States may also have special regulations regarding the operation of vehicles or equipment by employees. For example, certain employees may be required to obtain commercial driver's licenses.

In addition to local and state laws and regulations, Federal government regulations must also be considered. EPA (**Environmental Protection Act**) regulations can be extremely important and a violation thereof can often put a company out of business. Most of these regulations apply regardless of the size of the business or the way in which it is structured. OSHA regulations are also extremely important and any violation can result in a significant fine being assessed against a business. A newly enacted Federal Law, the **Americans with Disabilities Act**, requires those businesses with more than 15 employees to make reasonable accommodations regarding the employment of any handicapped person or the continued employment of a person who develops a disability. Furthermore, any business must make reasonable accommodations to make its business accessible to the handicapped.

Compliance with Laws

One of the most important considerations that any person operating a business must keep in mind is the payment of employee taxes. Those taxes which are withheld from the employee's wages are considered **trust fund taxes** and must be paid to the appropriate government agency

within the specifically prescribed time periods. Because the IRS (Internal Revenue Service) is generally not timely in monitoring and giving immediate notice of a failure to pay these taxes on time, it is often easy for a small business to increase its cash flow by delaying payment of trust fund taxes. Such a practice can be disastrous. For example, in Dan and Dave's partnership Dan writes all the checks and pays the bills. If the employee trust fund taxes are not paid, both Dan and Dave (even though Dave is not totally aware of what is being paid) can be personally liable for the amount of the trust fund taxes not paid. In addition to the personal liability, the IRS can assess a 100 percent penalty against both Dan and Dave for the failure to pay these taxes. Interest and penalties accrue with regard to these unpaid taxes. Furthermore, if the business fails, the IRS then looks to Dan and Dave for the payment of these trust fund taxes. It is an obligation of which Dan and Dave can never be relieved – not even in bankruptcy. In short, the IRS will continue collection efforts forever.

Often new businesses need to obtain proper permits from governmental agencies. For example, the building of a new garage on an adjoining lot might be perfectly legal and all building permits may be properly obtained; but, if the garage is used for business purposes, and the area is not zoned for commercial use, the building may become unusable unless a zoning variance can be obtained.

Liability

Anyone operating a business must be sensitive to the potential for vicarious liability: the liability which may be imposed upon the business entity or business person as a result of its association with employees, partners, and similar persons. As a general rule, an employer is responsible for the acts committed by his or her employees as long as the employee is acting within the scope of employment. In other words – if the employee is driving a company vehicle, is negligent in its operation, and injures an innocent party, the employer can be held equally liable for the damages caused.

In a partnership context, all partners are jointly and severally liable for any damages or losses caused by the tortuous conduct of any individual partner or if an employee breaches a trust.

A business should not assume that all of its employees are acting as subcontractors and that it need not obtain employer liability coverage. For example, if it is determined that the individuals are actually employees, it does not make any difference how they are paid or if taxes are withheld. In such a case an employer can be personally liable for any negligent action suit brought by an employee. Worker's compensation is not the only recovery process available to the employee.

OWNERSHIP CHANGES

At the time a business is organized, think about the potential termination or dissolution of that business. Events such as death, divorce, retirement, or sale can be dealt with much easier it these consequences are addressed at the time the business is organized.

Sole Proprietorship

If Dan is operating the business as a sole proprietorship and Dave is simply an employee, Dave's retirement is very simple. He is given a farewell dinner and a gold watch and the business continues uninterrupted. On the other hand, if Dan's wife decides to file for divorce, then the operation of the business may be substantially impaired. A divorce settlement may force the sale of the business. One way to protect against such a contingency is to execute a **buy-sell agreement** or an **anti-nuptial agreement** which, in the event of divorce, allows for the value of the business to be paid over a period of time. If Dan wishes to sell the business, he is the only person who needs to consent and the transaction is relatively easy. However, because it is a sole proprietorship, none of the tax attributes associated with the business can be transferred to another party. Rather, all attributes such as net operating loss, carryovers, and tax credit carryovers stay with Dan.

Partnerships

The termination of a partnership agreement is not necessarily an easy proposition. For example, if there are three partners and one decides to leave the business, the two remaining partners cannot simply carry on the business as usual. Legally, if one partner leaves, the partnership must be dissolved and a new partnership formed. There also may be significant tax implications associated with such an event. Furthermore, one partner cannot transfer or assign his or her interest without the consent of the other partners. A good way to provide for such contingencies is to execute a buy-sell agreement among the partners. This provides for one partner's interest being purchased by the others. As with sole proprietorships, tax attributes of a partnership are generally not transferred with the sale of the business assets.

Corporations

One advantage of a corporation is that it has continuity of existence. Regardless of a change in shareholders, directors, or officers, the corporation continues to exist as a business entity. Changes occur, new investors or shareholders come in, and others leave without disrupting the business operation. Corporations also offer the potential of having tax attributes transferred to new owners. However, such transfers are complicated; therefore, seek the advice of a tax attorney or accountant when the business is sold. Buy-sell agreements are also advantageous in a corporate context as between shareholders. It is not unusual for all shareholders to enter into an agreement which provides that their shares cannot be sold without first being offered to other shareholders or to the corporation. Another advantage of a corporation is that a portion of that corporation can be gifted to other individuals. For example, parents may give a small number of shares to children over a period of years, thus avoiding gift tax consequences and not disrupting the continued operation of the business.

ADDITIONAL READINGS

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3. Hamilton, W. H., Connelly, D. F., and Doster, D. H. *Agribusiness: An Entrepreneurial Approach.* Delmar, 1992. pp. 175-182.
4. Jenkens, M. D. *Starting and Operating a Business in Indiana – A Step-by- Step Guide.* Oasis, pp. 1-6.
5. Ryan, J. D., et. al. *Small Business, an Entrepreneur's Plan,* 2nd Edition. Harcourt Brace Jovanovich, 1990. pp. 234-241.

FOLLOW-UP ACTIVITIES

Activities to Increase Your Understanding of the Text

1. Write a suggested partnership agreement for Dave and Dan.
2. Search the library for sample partnership agreements to aid in writing one.

Activities to Aid Decision Making

1. Visit the local IRS office to find the tax forms your business will need to file.
2. Visit your attorney and discuss the best possible organization for your business.

Questions to Increase Your Understanding of the Text

1. What documents does a sole proprietor need to file?
2. What documents does a partnership need to file?
3. What documents does an S-corporation need to file?
4. What documents does a C-corporation need to file?
5. How do loan obligations affect individuals in a partnership? in an S-corporation? in a C-corporation?
6. When starting up a business, why should you consider the possible termination of that business?

Questions to Aid Decision Making

1. What legal council should I seek before going into business?
2. What laws and regulations apply to my business?
3. What licenses and permits do I need?
4. What tax forms must I file and what are the deadlines for filing each?

CHAPTER 22

When Help Is Needed

CHAPTER GOAL

- To identify some helpful sources.

Resources Available to the Small Business Owner

This text has cited many helpful sources; this chapter categorizes these sources. Just look for the desired heading.

BUSINESS MANAGEMENT AND PLANNING

Books

Christy, R. *The Complete Information Bank for Entrepreneurs*. Amacom, New York, 1993.

Massarela, G. J. *How to Develop a Results-driven Business Plan*. Amacom, New York, 1992.

Coopers & Lybrand. 1301 Avenue of The Americas, New York, NY. *Growth Company Starter Kit: "How to" for Business Plans, Financing, and Operations*. Other helps are also available.

Dearborn Trade. 155 North Wacker Drive, Chicago, IL 60606-1719. Telephone: (800) 245-2665. Books specifically geared to small business and finance.

Delmar Publishers, Inc. 3 Columbia Circle, Albany, NY, 12212.

Agribusiness: An Entrepreneurial Approach. Hamilton, Connelly, and Doster

Workbook - *Agribusiness: An Entrepreneurial Approach*. Connelly and Hamilton

Deloitte Haskins Sells Emerging Business Services. Business Review Checklist.

Entrepreneurship Educational Services, Inc. 5001N. 600E, Lafayette, IN 47905. Home page address – http://don.connelly@bizcity.com

Teacher's Resource Manual to Accompany: Agribusiness: An Entrepreneurial Approach. Hamilton and Connelly

Indiana Small Business Development Centers. One North Capitol, Suite 200, Indianapolis, IN 46204. *How To Prepare a Business Plan - Guidelines for Entrepreneurs.*

Ohio Agricultural Education Curriculum Materials Service. 254 Agricultural Administration Building, The Ohio State University, 2120 Fyffe Road, Columbus, OH 43210-1067. Telephone: (614) 292-4848, 24-hour FAX: (800) 292-4919. Catalog of educational materials.

Texas A&M University. Instructional Materials Service, College Station, TX. Has a series of management help publications for the beginning entrepreneur.

Internal Revenue Service

For tax assistance, see those references mentioned in Chapter 17, plus the following publications which are available from your local IRS office:

Tax Guide for Small Business, Publication 334. (Request latest version.)

Guide to Free Tax Services (Request current year.) Lists the services and toll-free numbers.

Recordkeeping for Individuals, Publication 552.

Library

Your local library has many resources which can provide you with information. Many of the magazines published in specialized industries are available or can be located by the reference librarian. Many reporting services reports are also available, some mentioned earlier in this text include *Best* and *Standard and Poors*. You may find the *Statistical Abstract of the United States* useful if you are thinking about entering a competitive industry.

Your library also has most of the commonly used Internal Revenue Service Forms during the tax season.

Magazines

There are so many specialized magazines on so many subjects, that it is impossible to list these here. Your librarian or magazine dealer can help you identify those of interest to you in the planning phase of your start-up.

One particular catalog worth mentioning is Entrepreneur Magazine Group's *Small Business Development Catalog*.

Entrepreneur Magazine Group
2392 Morse Avenue
P. O. Box 57050
Irvine, CA 92619-7050.

Service Organizations

THE ACTIVE CORPS OF EXECUTIVES (ACE)

The corps provides counseling and SBA-sponsored business workshops.

SMALL BUSINESS DEVELOPMENT CENTERS (SBDC)

Centers with these or similar names are found in cities across the nation. They provide help on state and local laws, regulations, licenses, and similar subjects. These centers are a public and private cooperative effort between the SBA and local groups. Your local phone directory may list their office or a local Chamber of Commerce representative can supply their telephone number.

CHAMBER OF COMMERCE

Most communities have a local Chamber of Commerce affiliated with the national organization. Their purpose is the promotion and improvement of the local business and social community.

This office can provide you with many business-related helps and information about the local community and the state.

INCUBATORS

Some areas have **business incubators** where a starting business can use space and have centralized telephone service and other office amenities. These services are available on a shared basis at low fees until the business becomes independent.

THE SERVICE CORP OF RETIRED EXECUTIVES (SCORE)

SCORE was started in 1964 and now has over 13,000 counseling volunteers who provide free business counseling. The organization was authorized and funded by the Small Business Administration. Composed of retired business executives, there are many chapters throughout the United States. There is probably one near you.

If there is no listing in your local telephone directory, contact the national headquarters for your nearest chapter. The telephone number is:

National SCORE Office
(800) 368-5855

SMALL BUSINESS ADMINISTRATION (SBA)

The Small Business Administration offers many publications to those interested in small business ownership and management. This organization makes the publications available at a nominal cost. To obtain a list of their materials (SBA Publication 115-A) contact your local SBA office or write to:

Small Business Administration
Office of Business Development
1411 L Street N. W.
Washington, DC 20416

Two publications in particular deserve special mention:

The Small Business Directory, Publications and Videotapes for Starting and Managing a Successful Small Business, and

Introduction to Strategic Planning by Michael L. Policastro.

These items contain valuable resource listings for entrepreneurs.

Two other publications (including subject bibliographies) – *Small Business* (SB-307) and *Business and Business Management* (SB-004) – are available free by writing to:

Superintendent of Documents
Washington, DC 20402

Another source to contact is the Small Business Answer Desk, telephone number (800) 368-5855 (Monday through Friday 9:00 a.m. to 5:00 p.m., EST) or 653-7561 in the Washington area. This is a nationwide service to help small business owners with any problems they may have. It can also refer you to appropriate governmental agencies, trade associations, and other information services.

OTHER NATIONAL ORGANIZATIONS

There are national business, professional, and trade organizations that publish magazines or provide services to their members. Some examples include the following:

1. National Federation of Independent Businesses (NFIB)
2. National Association of the Self-Employed
3. National Association of Independent Contractors
4. U.S. Chamber of Commerce
5. National Society of Certified Public Accountants

"Any County Medical"
PARTNERSHIP AGREEMENT

November 20, 19XX

1. **PURPOSE.** This charter establishes the company "Any County Medical" and documents all agreements between partners. The original baseline organization, strategy, and operating procedures are included herein. The purpose of the company is to create a health care clinic for providing quality medical care to the citizens of Any County while simultaneously providing employment and investment opportunities for the owners.
2. **TERMS.** The following terms will be used throughout the remainder of the document and are specifically defined below.
   a. ***The Company.*** Any County Medical
   b. ***The Voters.*** All persons with a voting percentage of ownership in the company
   c. ***The Investors.*** All persons with a nonvoting percentage of ownership in the company
   d. ***The Owners.*** All voters and investors in Any County Medical
   e. ***The Doctor.*** The practicing, resident doctor of the clinic
   f. ***The Accountant.*** The designated person responsible for the financial operations of the company
   g. ***The Account***. The company checking account
3. **OWNERSHIP.** The company is created as partnership between _____ and _____. Percentage of ownership is based upon amount of money invested in the company (see paragraph 5). Changes to this arrangement must be accomplished through the procedures set forth in this document.
4. **DECISION AUTHORITY.** The doctor maintains all decision-making authority for the day-to-day operations of the clinic, including personnel decisions such as hiring and firing of employees. Business decisions, generally defined as those decisions involving in excess of three hundred dollars ($300), will be decided by the voters. Each voter's input is weighted in accordance with their percent of ownership.
5. **OWNER INVESTMENTS.** Percent of ownership, both voting and nonvoting, will be published in each monthly report to owners (see paragraph 13).
   a. ***Amounts.*** The minimum initial capital investment into the company will be no less than $45,000 (forty-five thousand dollars) with a maximum amount of $60,000 (sixty thousand dollars). No individual owner may exceed $25,000 (twenty-five thousand dollars) of ownership.

b. ***Timeliness.*** Initial deposits must be received by the company by November 30, 19XX. Any investments received after this date will be discounted at a rate of 0.025 percent (twenty-five thousandths of one percent) per day towards ownership. No capital investments will be accepted after the company achieves break-even operations.

c. ***Break-even Operations.*** The break-even point is defined as two consecutive weeks where moneys received by the company meet or exceed monthly expenses (see paragraph 10.a.). The accountant will determine the date when break-even operations has occurred and notify all owners.

6. **ACCOUNTING PROCEDURES.**

   a. ***Company Accounts.*** Daily banking for the company will be conducted from a business (checking) account maintained locally. All receipts will be deposited within one hour of close of business daily. A maximum of $50.00 in change money may remain locked in a cash box or safe in the office overnight. Cash will be counted nightly with any excess deposited into the account. Cash withdrawals from the account are prohibited.

   b. ***Bookkeeping.*** All moneys received by the company shall be immediately stamped for deposit only into the account. All bookkeeping transactions (deposits and withdrawals from the account) will be recorded electronically by the bookkeeper in the software provided on a daily basis.

   c. ***Filing.*** Receipts for all expenditures will be forwarded to the accountant for filing and maintained on file for a minimum of seven years. Insurance claim paperwork will be maintained by the bookkeeper in the clinic and forwarded annually, in January, to the accountant for storage.

   d. ***Accounting.*** The accountant will download the bookkeeping spreadsheet data at least monthly via modem. Upon processing and analysis, the accountant will generate and disseminate the monthly financial report to the owners. Additionally, the accountant will provide financial guidance and present issues to the voters for resolution.

   e. ***Payroll.*** Payroll will be calculated by the accountant biweekly. Payroll data will be forwarded to the bookkeeper by noon on Friday for actual check writing and dissemination.

   f. ***Audits/Taxes.*** The company will arrange for an internal, self-initiated audit by an external, licensed agency annually. Results of the audit will be disseminated to all owners immediately upon receipt. Audits will occur in conjunction with federal tax preparation to be conducted by a licensed, bonded, tax preparation agency. Additionally, an audit will be executed when requested by a majority vote of the owners.

7. **INSURANCE.** Malpractice insurance for the doctor will be considered a business expense to be paid from the account. The company will carry full replacement cost property insurance for all office equipment and liability insurance of at least one million dollars ($1,000,000) for the clinic, unless already provided for in the property lease.

8. **COMPENSATION.**

   a. ***Starting salaries.*** Initial salaries are presented in gross pay format (before taxes and other deductions):

      1) DOCTOR. One thousand dollars ($1,000) per week.

      2) BOOKKEEPER. Three hundred seventy-five dollars ($375) per week.

      3) ACCOUNTANT. Two hundred thirty dollars ($230) per week.

   b. ***Commissions.*** Payment of commissions will commence in accordance with the payment schedule in paragraph 10. Every dollar spent towards commission will be prorated between applicable persons in order to have each person reach salary caps simultaneously. Salary caps (gross pay) and percentage of commission are provided below:

      1) DOCTOR. Eighteen hundred forty-five dollars ($1,845) per week (72 percent).

      2) BOOKKEEPER. Four hundred forty-five dollars ($445) per week (8 percent).

      3) ACCOUNTANT. Two hundred thirty dollars ($230) per week (20 percent).

   c. ***Pay Raises.*** All employees, both salary and hourly, will receive an annual cost of living raise. Raises will occur on January 1 beginning in 19XX. Other pay raises require the majority consent of voters.

   d. ***Reimbursements.*** Maximum efforts will be employed to ensure that company expenses are paid for via the account. Reimbursements require the approval of a majority of voters.

   e. ***Benefits.***

      1) VACATIONS. Salaried employees will be authorized two (2) weeks of paid vacation per calendar year. Vacation times must be coordinated in advance to minimize disruption of the clinic's operation. An hourly employee vacation program will be established in writing by the doctor.

      2) HEALTH INSURANCE COVERAGE. The company will offer health insurance coverage for all owners of the company and their families. Company employees will be offered health insurance coverage after ninety (90) days of satisfactory job performance. Details of these offers will be published as an addendum to this document prior to January 1, 19XX.

      3) PENSION PLANS. The company will offer a retirement program for all owners and employees of the company. Details of this program will be published as an addendum to this document prior to April 1, 19XX.

9. **PROFIT SHARING.** Profits are defined as those moneys available after full satisfaction of all business expenses and the payment schedule as specified in paragraph 10. Distribution of profits to owners will be via company check and split in accordance with percent of ownership.

10. **PAYMENT SCHEDULE.** All moneys received by the company will be allocated in accordance with the priority scheme specified below. Deviations from this plan require majority consent of the voters.

    a. ***Monthly Operating Expenses.*** This includes – but is not limited to – rent, utilities, leases, supplies, outside agency services, salaries, insurance, taxes, and advertising.

    b. ***Financing Repayment.*** This includes any moneys owed by the company on extended credit. Examples include building preparation fees and equipment leasing (pay-off option).

    c. ***Capital Reinvestment.*** This includes all equipment and improvements to upgrade the clinic into a full-service medical center. The doctor will provide a list of suggested capital improvements to the voters for review. Capital improvements will be approved by a majority consent of voters.

    d. ***Commissions.*** (see paragraph 8.B.)

    e. ***Investment.*** The company will increase/maintain its account at a level equal to two months of operating expenses. An additional amount of money equal to four months of operating expenses will be accumulated and invested in accordance with paragraph 11.

    f. ***Profit Sharing.*** (see paragraph 9). Profit sharing will not begin until priorities B through E above have been completed.

11. **COMPANY INVESTMENT STRATEGY.** The company will accumulate/maintain an emergency fund equal to four months of operating expenses. Moneys will be invested only in financial mediums with a "low" risk rating and liquidity of one week or less. The accountant will be responsible for maintaining the investments for the company and reporting all proposed changes in investment vehicles to the voters. Changes in the investment strategy requires majority consent of the voters.

12. **CALCULATION OF NET WORTH.** The net worth of the company will be calculated upon the request of any owner. Calculation will use the standard assets minus liabilities accounting approach.

13. **REPORTS.** The accountant will prepare and disseminate a monthly report for the owners. The report is due to the owners by the 10th of every month.

14. **INCORPORATING.** The company can incorporate only upon the unanimous consent of the voters. The accountant will recommend the action to all voters at the appropriate time. As a minimum, the issue must be reviewed upon each renewal of this document (see paragraph 22).

15. **DIVERSIFICATION.** The company can diversify to other business ventures only upon unanimous consent of the voters. Motions to diversify can be initiated by any owner at any time.

16. **CHANGE IN DOCTOR STATUS.** Should the doctor become incapable of performing his/her duties for a short period of time, a fill-in (replacement) doctor will be sought. Extended incapacitation (in excess of two months) will be considered sufficient grounds for immediate termination of the company (see paragraph 21). Majority consent of the voters is required to extend this period for recovery or full doctor replacement.

17. **INDEBTEDNESS.** The company is prohibited from financing any moneys without the majority consent of the voters. Initial exceptions to this policy are leases for the x-ray, physical therapy, and computer equipment acquired at company start-up.

18. **DEATH OF AN OWNER.** Upon the death of an owner, the surviving voters have the authority, on unanimous consent, to buy the deceased owner's percentage of the company in accordance with paragraph 20.a. Proceeds of the sale are distributed in accordance with the deceased owner's remaining estate. Otherwise, the deceased owner's percentage of the company reverts to whomever is specified in the deceased owner's will.

19. **DIVORCE OF AN OWNER**. An owner's percentage ownership of the company may not be transferred to a spouse in divorce proceedings. Should this document be overruled in court, the remaining owners have the authority to buy the divorcing owner's percentage of the company in accordance with paragraph 20.a.

20. **CHANGE OF OWNERSHIP.**

    a. ***Buy-outs.*** The total sale of an owner's percentage under certain conditions is specified in this document. When implemented, the net worth of the company will be calculated in accordance with paragraph 12. The transaction will be paid via cashier's check for an amount equal to the percentage of the company's net worth.

    b. ***Sell-outs.*** An owner may opt to liquidate his or her percentage of the company with 30 days minimum notice. This option is available only after the company has begun paying profit sharing. The accountant will calculate the company's net worth on the day of sale and redistribute the percent ownership to the remaining owners in direct proportion to their current levels (prorated). On transaction day the selling owner will begin receiving 100 percent of all profit-sharing moneys until an amount equal to his or her percent ownership has been obtained.

    c. ***Sales to Outside Persons/Agencies.*** Sale of any ownership of this company to an outside person or agency is prohibited without unanimous consent of the voters.

21. **COMPANY TERMINATION.** Termination procedures for the company may be initiated for two reasons: running out of capital (paragraphs 5 and 17) and operating without a resident doctor for extended time periods (paragraph 16). Upon initiation, the following procedures will be used:

    a. ***Equipment Liquidation.*** All company equipment will be sold for the highest amount possible as soon as possible. Owners may purchase equipment at the depreciated or fair market value, whichever is higher. Proceeds will be deposited into the account.

    b. ***Severance Pay.*** Salary employees will receive no severance pay for company termination. Hourly employees will receive two weeks of severance pay upon employment termination.

    c. ***Debits.*** All outstanding claims against the company will be paid in full. The company will continue its account for a minimum of 30 days beyond clinic closing in order to ensure receipt of all debit notices.

d. ***Cash Shortfalls.*** The owners will supplant the account for any cash shortfall when settling termination costs. Each owner will be responsible in accordance with percent ownership. Payments must be received within 14 days of notification.

e. ***Cash Surplus.*** Any surplus in the account will be split among owners in accordance with percent of ownership.

22. **DOCUMENT REVIEW**. This document will remain in force until superseded by a replacement agreement. Replacement must be signed by all owners and filed at a mutually agreed upon site for safekeeping. This document will be reviewed annually on its anniversary or sooner if an owner so requests.

_____

_____ *(date)*

_____

_____ *(date)*

ADDENDUM. The following items will be added as specified:

1. Vacation program
2. Health insurance program
3. Pension program
4. Monthly report format

APPENDIX B

Sample Articles of Incorporation

The undersigned incorporator or incorporators, desiring to form a corporation (hereinafter referred to as the "Corporation") pursuant to the provisions of the Indiana Business Corporation Law, Ind. Code Section 23-1-17 et seq., (such act, as amended from time to time, and its successors are hereinafter referred to as the "Act"), execute the following articles of incorporation.

ARTICLE I

Name

The name of this Corporation is _____ Inc.

ARTICLE II

Purposes and Powers

1. The purpose for which the Corporation is formed is:

   a. To carry on a general investment and management consultant and advisory business relating to investments and the operation of businesses, plants, properties, and real and personal property of every kind, in the United States and foreign countries, subject to the applicable laws thereof. To maintain executive and operating personnel for the purpose of consulting with and advising others in all matters relating to the investments and the management and operation of businesses and other properties of every kind. To furnish business investment and management plans and programs, to formulate policies, and generally to advise and assist others, under contract or otherwise, in the management of their businesses, plant, properties, and development of individual and corporate business. To conduct research and to investigate businesses and enterprises of every kind and description throughout the world in order to secure information and data for capital investment, both for its own account and as agent for others. To engage in capital ventures and business enterprises of every kind and description, whether as a promoter, partner, member, or associate, or as a manager of other such enterprises.

   b. To transact any and all lawful business for which corporations may be incorporated under the Act.

2. Subject to any limitation or restriction imposed by the Act, any other law, or any provisions of these articles of incorporation, the Corporation shall have:

   a. The same capacity to act as possessed by natural persons and to do everything necessary, advisable or convenient for the accomplishment of any of the purposes herein before set forth, or which shall at anytime appear conducive to or expedient for the protection or benefit of the Corporation, and to do all other things incidental thereto or connected therewith which are not forbidden by law;

   b. The power to carry out the purposes herein before set forth in any state, territory district, or possession of the United States, or in any foreign country, to the extent that such purposes are not forbidden by law of any such state, territory, district or possession of the United States or by such foreign country; and

   c. The power to have, exercise and enjoy in furtherance of the purposes hereinafter set forth all the general rights, privileges and powers granted to corporations by the Act, and by the common law.

ARTICLE III

Registered Office and Registered Agent

SECTION 1. REGISTERED OFFICE

The street address for the registered office of the Corporation located in Indiana is _____, Indiana.

SECTION 2. REGISTERED AGENT

The name of the registered agent whose business office is identical with the registered office is _____.

ARTICLE IV

Terms of Shares

SECTION 1. NUMBER

The total number of shares which the Corporation has authority to issue is one thousand (1,000).

SECTION 2. DESIGNATION OF CLASSES

All the authorized shares of the Corporation shall be of one class only and be designated common stock. The common stock of the Corporation shall in all respects entitle the holder to the same rights and preferences, and subject the holder to the same qualifications, limitations and restrictions as all the other shareholders of common stock.

SECTION 3. ISSUANCE AND CONSIDERATION

The common stock may be issued for such an amount of consideration as may be fixed from time to time by the board of directors.

SECTION 4. VOTING RIGHTS

Subject to any specific restrictions imposed by the Act, each holder of common stock shall be entitled to cast one vote for each share of such stock standing in the shareholder's name on the Corporation's books on the specified record date on each matter upon which the shareholder is entitled to vote. At any meeting of shareholders, the holders of a majority of the shares entitled by these articles of incorporation to be voted on the business to be transacted at such meeting, represented threat in person or proxy, shall constitute a quorum. At any meeting of the shareholders at which a quorum is present, action on a matter (other than the election of directors) is approved if the votes cast favoring the action exceed the votes cast opposing, unless a greater affirmation vote is required by the Act or these articles of incorporation. Notwithstanding the foregoing provisions, the following actions require the affirmative vote of a majority of the issued and outstanding shares entitled to vote on the proposed action:

a. Authorization by the shareholders of indemnification and advances for expenses (Ind. Code Section 23-1-37-15);

b. Amendments to the articles of incorporation which would give rise to dissenters' rights [Ind. Code Section 23-1-38-3(e)(1)], unless the board of directors acting pursuant to Ind. Code Section 23-1-40-3(c) requires a greater vote;

c. Adoption of a plan of merger or share exchange [Ind. Code Section 23-1-40-3(e)], unless the board of directors acting pursuant to Ind. Code Section 23-1-40-3(c) requires a greater vote;

d. Sale, lease, exchange or other disposition of all or substantially all of the corporate property other than in the usual and regular course of business [Ind. Code Section 23-1-41-2(e)], unless the board of directors acting pursuant to Ind. Code Section 23-1-41-2(c) requires a greater vote; and

e. Voluntary dissolution of the Corporation (Ind. Code Section 23-1-45-2(c) requires a greater vote.

Directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at which a quorum is present.

SECTION 5. DIVIDENDS

The board of directors shall have the power to declare and pay dividends on the outstanding shares of common stock to the extent permitted by the Act.

SECTION 6. DISSOLUTION

In the event of any voluntary or involuntary liquidation, dissolution, or winding up of the Corporation, the holders of the shares of the common stock of the Corporation shall be entitled, after due payment or provision for payment of the debts and other liabilities of the Corporation, to share equitably in the remaining net assets of the Corporation.

SECTION 7. NO PREEMPTIVE RIGHTS

Shareholders shall have no preemptive rights to subscribe to purchase of any shares of common stock or other securities of the Corporation.

ARTICLE V

Directors

SECTION 1. NUMBER

The initial board of directors is composed of *two (2)* members. The number of directors shall be specified by, or fixed in accordance with, from time to time, the bylaws of the Corporation. In the absence of a bylaw specifying or fixing the number of directors, the number shall be the number specified herein for the initial board of directors. The bylaws may prove for staggering the terms of the directors.

SECTION 2. NAMES AND POST OFFICE ADDRESSES OF THE DIRECTORS

The names and post office addresses of the initial board of directors of the Corporation are:

_____

_____

SECTION 3. DIRECTION OF PURPOSE AND EXERCISE OF POWERS

The board of directors, subject to any specific limitations or restrictions imposed by the Act or these articles of incorporation, shall direct the carrying out of the purposes and exercise the powers of the Corporation, without previous authorization or subsequent approval by the shareholders of the Corporation.

ARTICLE VI

Incorporator

The name and post office address of the incorporator of the Corporation is:

_____

ARTICLE VII

Provisions for Regulation of Business and Conduct of Affairs of Corporation

SECTION 1. INDEMNIFICATION

a. Every person who is or was a director of the Corporation (as defined in Ind. Code Section 23-1-37-2) shall be indemnified by the Corporation against all liability and reasonable expenses (as such terms are defined in Ind. Code Section 23-1-37-3 and 4) incurred by such person in any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative and whether formal or informal, because of such person is or was a director of the Corporation, provided that such person is determined

in the manner specified in Ind. Code Section 23-1-37-12 to have met the standard of conduct specified in Ind. Code Section 23-1-37-10, the Corporation shall advance to such person the reasonable expense incurred by him or her in connection with any such action, suit or proceeding. Upon demand for indemnification or advancement of expenses, as the case may be, the Corporation shall proceed as provided in Ind. Code Section 23-1-37-12 to determine whether such person is entitled thereto. Every person who is or was an officer of the Corporation shall be indemnified, and shall be entitled to an advancement of expenses, to the same extent as if the same person were a director.

b. If the Corporation indemnifies or advances expenses to a director in connection with a proceeding by or in the right of the Corporation, the Corporation shall report the indemnification or advance in writing to the shareholders with or before the notice of the next shareholders' meeting as provided in Ind. Code Section 23-1-53-2(a).

c. Nothing contained in this Section 1 shall limit or preclude the exercise of any right provided under the Act, these articles of incorporation, the Corporation's bylaws, any general or specific action of the board of directors or the shareholders of the Corporation, or any contract relating to indemnification of or the advancement of expenses to any director, officer, employee or agent of the Corporation, or the ability of the Corporation to otherwise indemnify or advance expenses to any director, officer, employee or agent.

SECTION 2. CONFLICT OF INTEREST TRANSACTION

A conflict of interest transaction, as defined in Ind. Code Section 23-1-35-2(a), is not voidable by the Corporation provided the conflict of interest transaction satisfies the provisions specified in Ind. Code Section 23-1-35-2.

SECTION 3. CODE OF BYLAWS

The board of directors of the Corporation shall have the power, without the assent or vote of the shareholders, to make, alter, amend or repeal the Code of Bylaws of the Corporation.

SECTION 4. AMENDMENTS OF ARTICLES OF INCORPORATION

The Corporation reserves the right to amend, alter, change or repeal any provision contained in the articles of incorporation or in any amendment hereto, or to add any provision to the article so incorporation or to any amendment hereto, in any manner now or hereafter prescribed or permitted by the provisions of the Act, or by the provisions of any other applicable statue of the state of Indiana; and all rights conferred upon shareholders in the articles of incorporation or by any amendment hereto are granted subject to this reservation.

IN WITNESS WHEREIF, the undersigned, being the incorporator designated herein, executes these articles of incorporation on this _____ day of _____, 19XX, and affirm under penalties of perjury that the statements contained herein are true.

_____

Checklist for Incorporation

Complete the following actions when you are considering incorporation. Work with your attorney to complete the process.

_____ 1. Choose a corporate name.

_____ 2. Ask the Secretary of State's Office to check the corporate name you want to use.

_____ 3. Send the filing fee for the corporate name to reserve it for 30 days.

_____ 4. Write your articles of incorporation and proposed bylaws.

_____ 5. Determine the initial capitalization and source of the funds.

_____ 6. Determine the number of shares to issue.

_____ 7. Determine whether to begin as an S-corporation.

_____ 8. Obtain an employer's identification number.

_____ 9. File the incorporation papers.

_____ 10. Complete the title changes resulting from the incorporation.

_____ 11. Hold the organizational meeting and elect the officers.

SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service (O)

Profit or Loss From Business

(Sole Proprietorship)

▶ **Partnerships, joint ventures, etc., must file Form 1065.**

▶ **Attach to Form 1040 or Form 1041.** ▶ **See Instructions for Schedule C (Form 1040).**

OMB No. 1545-0074

1994

Attachment Sequence No. 09

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see page C-1) | **B Enter principal business code** (see page C-6) ▶

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN), if any**

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Method(s) used to value closing inventory: (1) ☐ Cost (2) ☐ Lower of cost or market (3) ☐ Other (attach explanation) (4) ☐ Does not apply (if checked, skip line H)

		Yes	No
H	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation		
I	Did you "materially participate" in the operation of this business during 1994? If "No," see page C-2 for limit on losses		
J	If you started or acquired this business during 1994, check here ▶ ☐		

Part I Income

1	Gross receipts or sales. **Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here* ▶ ☐	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 40 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-2)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		19	Pension and profit-sharing plans	19
9	Bad debts from sales or services (see page C-3)	9		20	Rent or lease (see page C-4):	
				a	Vehicles, machinery, and equipment	20a
10	Car and truck expenses (see page C-3)	10		b	Other business property	20b
11	Commissions and fees	11		21	Repairs and maintenance	21
12	Depletion	12		22	Supplies (not included in Part III)	22
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13		23	Taxes and licenses	23
				24	Travel, meals, and entertainment:	
				a	Travel	24a
14	Employee benefit programs (other than on line 19)	14		b	Meals and entertainment	
15	Insurance (other than health)	15		c	Enter 50% of line 24b subject to limitations (see page C-4)	
16	Interest:			d	Subtract line 24c from line 24b	24d
a	Mortgage (paid to banks, etc.)	16a		25	Utilities	25
b	Other	16b		26	Wages (less employment credits)	26
17	Legal and professional services	17		27	Other expenses (from line 46 on page 2)	27
18	Office expense	18				

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	
29	Tentative profit (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If a loss, you MUST go on to line 32.	31	
32	If you have a loss, check the box that describes your investment in this activity (see page C-5). • If you checked 32a, enter the loss on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you MUST attach **Form 6198.**	32a ☐ All investment is at risk 32b ☐ Some investment is not at risk	

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P **Schedule C (Form 1040) 1994**

(continued on next page)

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Schedule C (Form 1040) 1994 Page 2

Part III **Cost of Goods Sold** (see page C-5)

33	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	33	
34	Purchases less cost of items withdrawn for personal use	34	
35	Cost of labor. Do not include salary paid to yourself	35	
36	Materials and supplies	36	
37	Other costs	37	
38	Add lines 33 through 37	38	
39	Inventory at end of year	39	
40	**Cost of goods sold.** Subtract line 39 from line 38. Enter the result here and on page 1, line 4	40	

Part IV **Information on Your Vehicle.** Complete this part **ONLY** if you are claiming car or truck expenses on line 10 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-3 to find out if you must file.

41 When did you place your vehicle in service for business purposes? (month, day, year) ▶ / /

42 Of the total number of miles you drove your vehicle during 1994, enter the number of miles you used your vehicle for:

a Business b Commuting c Other

43	Do you (or your spouse) have another vehicle available for personal use?	☐ Yes	☐ No
44	Was your vehicle available for use during off-duty hours?	☐ Yes	☐ No
45a	Do you have evidence to support your deduction?	☐ Yes	☐ No
b	If "Yes," is the evidence written?	☐ Yes	☐ No

Part V **Other Expenses.** List below business expenses not included on lines 8–26 or line 30.

46	**Total other expenses.** Enter here and on page 1, line 27	46

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Form **8829**

Department of the Treasury
Internal Revenue Service (O)

Expenses for Business Use of Your Home

▶ **File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.**

▶ **See separate instructions.**

OMB No. 1545-1266

1994

Attachment Sequence No. **66**

Name(s) of proprietor(s) | Your social security number

Part I Part of Your Home Used for Business

1 Area used regularly and exclusively for business, regularly for day care, or for inventory storage. See instructions 1

2 Total area of home 2

3 Divide line 1 by line 2. Enter the result as a percentage . . . . . 3 %

- **For day-care facilities not used exclusively for business, also complete lines 4-6.**
- **All others, skip lines 4-6 and enter the amount from line 3 on line 7.**

4 Multiply days used for day care during year by hours used per day . 4 hr.

5 Total hours available for use during the year (365 days × 24 hours). See instructions 5 8,760 hr.

6 Divide line 4 by line 5. Enter the result as a decimal amount . . . 6

7 Business percentage. For day-care facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 . . . ▶ 7 %

Part II Figure Your Allowable Deduction

8 Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions 8

See instructions for columns (a) and (b) before completing lines 9-20.

	(a) Direct expenses	(b) Indirect expenses
9 Casualty losses. See instructions	9	
10 Deductible mortgage interest. See instructions	10	
11 Real estate taxes. See instructions	11	
12 Add lines 9, 10, and 11	12	
13 Multiply line 12, column (b) by line 7		13
14 Add line 12, column (a) and line 13		14
15 Subtract line 14 from line 8. If zero or less, enter -0-		15
16 Excess mortgage interest. See instructions	16	
17 Insurance	17	
18 Repairs and maintenance	18	
19 Utilities	19	
20 Other expenses. See instructions	20	
21 Add lines 16 through 20	21	
22 Multiply line 21, column (b) by line 7		22
23 Carryover of operating expenses from 1993 Form 8829, line 41		23

24 Add line 21 in column (a), line 22, and line 23 24

25 Allowable operating expenses. Enter the **smaller** of line 15 or line 24 25

26 Limit on excess casualty losses and depreciation. Subtract line 25 from line 15 26

27 Excess casualty losses. See instructions 27

28 Depreciation of your home from Part III below 28

29 Carryover of excess casualty losses and depreciation from 1993 Form 8829, line 42 . . . 29

30 Add lines 27 through 29 30

31 Allowable **excess** casualty losses and depreciation. Enter the **smaller** of line 26 or line 30 . . 31

32 Add lines 14, 25, and 31 32

33 Casualty loss portion, if any, from lines 14 and 31. Carry amount to **Form 4684,** Section B . . 33

34 Allowable **expenses** for business use of your home. Subtract line 33 from line 32. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶ 34

Part III Depreciation of Your Home

35 Enter the **smaller** of your home's adjusted basis or its fair market value. See instructions . . 35

36 Value of land included on line 35 36

37 Basis of building. Subtract line 36 from line 35 37

38 Business basis of building. Multiply line 37 by line 7 38

39 Depreciation percentage. See instructions . . . . . 39 %

40 Depreciation allowable. Multiply line 38 by line 39. Enter here and on line 28 above. See instructions 40

Part IV Carryover of Unallowed Expenses to 1995

41 Operating expenses. Subtract line 25 from line 24. If less than zero, enter -0- 41

42 Excess casualty losses and depreciation. Subtract line 31 from line 30. If less than zero, enter -0- . 42

For **Paperwork Reduction Act Notice, see page 1 of separate instructions.** Printed on recycled paper Cat. No. 13232M Form **8829** (1994)

*U.S. Government Printing Office: 1994 — 375-468

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Form **941**
(Rev. April 1994)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax Return

4141

▶ **See separate instructions for information on completing this return.**

Please type or print.

OMB No. 1545-0029

Enter state code for state in which deposits made ▶ (see page 2 of instructions).

Name (as distinguished from trade name)

Trade name, if any

Address (number and street)

Date quarter ended

Employer identification number

City, state, and ZIP code

T
FF
FD
FP
I
T

If address is different from prior return, check here ▶ ☐

IRS Use

If you do not have to file returns in the future, check here ▶ ☐ and enter date final wages paid ▶

If you are a seasonal employer, see **Seasonal employers** on page 2 and check here (see instructions) ▶ ☐

1	Number of employees (except household) employed in the pay period that includes March 12th ▶		
2	Total wages and tips subject to withholding, plus other compensation	2	
3	Total income tax withheld from wages, tips, and sick pay	3	
4	Adjustment of withheld income tax for preceding quarters of calendar year	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	
6a	Taxable social security wages $ × 12.4% (.124) =	6a	
b	Taxable social security tips $ × 12.4% (.124) =	6b	
7	Taxable Medicare wages and tips $ × 2.9% (.029) =	7	
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7). Check here if wages are not subject to social security and/or Medicare tax ▶ ☐	8	
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) Sick Pay $ _____ ± Fractions of Cents $ _____ ± Other $ _____ =	9	
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions)	10	
11	**Total taxes** (add lines 5 and 10)	11	
12	Advance earned income credit (EIC) payments made to employees, if any	12	
13	Net taxes (subtract line 12 from line 11). **This should equal line 17, column (d) below** (or line D of Schedule B (Form 941))	13	
14	Total deposits for quarter, including overpayment applied from a prior quarter	14	
15	**Balance due** (subtract line 14 from line 13). Pay to Internal Revenue Service	15	
16	**Overpayment,** if line 14 is more than line 13, enter excess here ▶ $ _____ and check if to be: ☐ Applied to next return **OR** ☐ Refunded.		

- **All filers:** If line 13 is less than $500, you need not complete line 17 or Schedule B.
- **Semiweekly depositors:** Complete Schedule B and check here ▶ ☐
- **Monthly depositors:** Complete line 17, columns (a) through (d) and check here ▶ ☐

17 Monthly Summary of Federal Tax Liability.

(a) First month liability	(b) Second month liability	(c) Third month liability	(d) Total liability for quarter

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Print Your Name and Title ▶ Date ▶

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 17001Z Form **941** (Rev. 4-94)

*U.S. Government Printing Office: 1994 — 301-629/00153

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Form **940**

Department of the Treasury
Internal Revenue Service

Employer's Annual Federal Unemployment (FUTA) Tax Return

▶ For Paperwork Reduction Act Notice, see separate instructions.

OMB No. 1545-0028

1993

T	
FF	
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FP	
I	
T	

Name (as distinguished from trade name) — Calendar year

If incorrect, make any necessary change. ▶

Trade name, if any

Address and ZIP code

Employer identification number

A	Are you required to pay unemployment contributions to only one state? (If no, skip questions B through D.)	☐ Yes	☐ No
B	Did you pay all state unemployment contributions by January 31, 1994? (If a 0% experience rate is granted, check "Yes.") (If no, skip questions C and D.)	☐ Yes	☐ No
C	Were all wages that were taxable for FUTA tax also taxable for your state's unemployment tax? (If no, skip D.)	☐ Yes	☐ No
D	Did you pay all wages in states or territories other than the U.S. Virgin Islands?	☐ Yes	☐ No

If you answered "No" to any of these questions, you must file Form 940. If you answered "Yes" to all the questions, you may file Form 940-EZ, which is a simplified version of Form 940. You can get Form 940-EZ by calling 1-800-TAX-FORM (1-800-829-3676).

E If you will not have to file returns in the future, check here, complete, and sign the return ▶ ☐

F If this is an Amended Return, check here ▶ ☐

Part I Computation of Taxable Wages

1	Total payments (including exempt payments) during the calendar year for services of employees		1	
2	Exempt payments. (Explain each exemption shown, attach additional sheets if necessary.) ▶	Amount paid		
		2		
3	Payments of more than $7,000 for services. Enter only amounts over the first $7,000 paid to each employee. Do not include payments from line 2. The $7,000 amount is the Federal wage base. Your state wage base may be different. **Do not use the state wage limitation**	3		
4	Total exempt payments (add lines 2 and 3)		4	
5	**Total taxable wages** (subtract line 4 from line 1, enter result, and go to part II) ▶		5	

Be sure to complete both sides of this return and sign in the space provided on the back. Cat. No. 11234O Form **940** (1993)

(continued on next page)

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Form 940 (1993) Page 2

Part II Tax Due or Refund

1	Gross FUTA tax. Multiply the wages in Part I, line 5, by .062	1	
2	Maximum credit. Multiply the wages in Part I, line 5, by .054	2	
3	**Computation of tentative credit (Note:** *All taxpayers must complete the applicable columns.*)		

Note: *The additional credit shown in column (h) is limited to 3% of the taxable payroll for the U.S. Virgin Islands. Use 3% (.03) in column (f). See Part II, line 3, columns (f) and (h), on page 4 of the separate instructions.*

(a) Name of state	(b) State reporting number(s) as shown on employer's state contribution returns	(c) Taxable payroll (as defined in state act)	(d) State experience rate period From	(d) To	(e) State experience rate	(f) Contributions if rate had been 5.4% (col. (c) x .054)	(g) Contributions payable at experience rate (col. (c) x col. (e))	(h) Additional credit (col. (f) minus col. (g). If 0 or less, enter 0.)	(i) Contributions actually paid to state
3a	Totals ▶								

3b	**Total tentative credit** (add line 3a, columns (h) and (i) only—see instructions for limitations on late payments) ▶		
4			
5			
6	**Credit:** Enter the smaller of the amount in Part II, line 2, or line 3b	6	
7	**Total FUTA tax** (subtract line 6 from line 1)	7	
8	Total FUTA tax deposited for the year, including any overpayment applied from a prior year	8	
9	**Balance due** (subtract line 8 from line 7). This should be $100 or less. Pay to the Internal Revenue Service. See page 2 of the separate instructions for details ▶	9	
10	**Overpayment** (subtract line 7 from line 8). Check if it is to be: ☐ **Applied to next return,** or ☐ **Refunded** ▶	10	

Part III Record of Quarterly Federal Unemployment Tax Liability *(Do not include state liability)*

Quarter	First	Second	Third	Fourth	Total for year
Liability for quarter					

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was or is to be deducted from the payments to employees.

Signature ▶ Title (Owner, etc.) ▶ Date ▶

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APPENDIX H

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Rents $	OMB No. 1545-0115	Miscellaneous Income
	2 Royalties $	1993	
	3 Prizes, awards, etc. $		
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $	5 Fishing boat proceeds $	
RECIPIENT'S name	6 Medical and health care payments $	7 Nonemployee compensation $	
Street address (including apt. no.)	8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	Copy 1 For State Tax Department
City, state, and ZIP code	10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional)	12 State/Payer's state number		

Form **1099-MISC** Department of the Treasury - Internal Revenue Service

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Form **SS-8**
(Rev. July 1993)
Department of the Treasury
Internal Revenue Service

Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding

OMB No. 1545-0004
Expires 7-31-96

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us this information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **recordkeeping,** 34 hr., 55 min., **learning about the law or the form,** 6 min. and **preparing and sending the form to IRS,** 40 min. If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the **Internal Revenue Service,** Attention: Reports Clearance Officer, T:FP, Washington, DC 20224; and the **Office of Management and Budget,** Paperwork Reduction Project (1545-0004), Washington, DC 20503. **DO NOT** send the tax form to either of these offices. Instead, see **General Information** for where to file.

Purpose

Employers and workers file Form SS-8 to get a determination as to whether a worker is an employee for purposes of Federal employment taxes and income tax withholding.

General Information

This form should be completed carefully. If the firm is completing the form, it should be completed for **ONE** individual who is representative of the class of workers whose status is in question. If a written determination is desired for more than one class of workers, a separate Form SS-8 should be completed for one worker from each class whose status is typical of that class. A written determination for any worker will apply to other workers of the same class if the facts are not materially different from those of the worker whose status was ruled upon.

Please return Form SS-8 to the Internal Revenue Service office that provided the form. If the Internal Revenue Service did not ask you to complete this form but you wish a determination on whether a worker is an employee, file Form SS-8 with your District Director.

Caution: *Form SS-8 is* ***not*** *a claim for refund of social security and Medicare taxes or Federal income tax withholding. Also, a determination that an individual is an employee does not necessarily reduce any current or prior tax liability. A worker must file his or her income tax return even if a determination has not been made by the due date of the return.*

Name of firm (or person) for whom the worker performed services	Name of worker
Address of firm (include street address, apt. or suite no., city, state, and ZIP code)	Address of worker (include street address, apt. or suite no., city, state, and ZIP code)
Trade name	Telephone number (include area code) ( ) — Worker's social security number — —
Telephone number (include area code) ( ) — Firm's taxpayer identification number —	

Check type of firm for which the work relationship is in question:
☐ **Individual** ☐ **Partnership** ☐ **Corporation** ☐ **Other** (specify) ▶

Important Information Needed to Process Your Request

This form is being completed by: ☐ Firm ☐ Worker

If this form is being completed by the worker, the IRS **must** have your permission to disclose your name to the firm.

Do you object to disclosing your name and the information on this form to the firm? . . . . . ☐ **Yes** ☐ **No**

If you answer "Yes," the IRS cannot act on your request. **DO NOT complete the rest of this form unless the IRS asks for it.**

Under section 6110 of the Internal Revenue Code, the information on this form and related file documents will be open to the public if any ruling or determination is made. However, names, addresses, and taxpayer identification numbers must be removed before the information can be made public.

Is there any other information you want removed? . . . . . ☐ **Yes** ☐ **No**

If you check "Yes," we cannot process your request unless you submit a copy of this form and copies of all supporting documents showing, in brackets, the information you want removed. Attach a separate statement telling which specific exemption of section 6110(c) applies to each bracketed part.

This form is designed to cover many work activities, so some of the questions may not apply to you. ***You must answer ALL items or mark them "Unknown" or "Does not apply."*** *If you need more space, attach another sheet.*

Total number of workers in this class. (Attach names and addresses. If more than 10 workers, attach only 10.) ▶ _____

This information is about services performed by the worker from _____ (month, day, year) to _____ (month, day, year)

Is the worker still performing services for the firm? . . . . . ☐ **Yes** ☐ **No**

If "No," what was the date of termination? ▶ _____ (month, day, year)

Cat. No. 16106T — Form **SS-8** (Rev. 7-93)

(continued on next page)

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Form SS-8 (Rev. 7-93) Page 2

1a Describe the firm's business

b Describe the work done by the worker

2a If the work is done under a written agreement between the firm and the worker, attach a copy.

b If the agreement is not in writing, describe the terms and conditions of the work arrangement

c If the actual working arrangement differs in any way from the agreement, explain the differences and why they occur

3a Is the worker given training by the firm? ☐ Yes ☐ No

If "Yes": What kind?

How often?

b Is the worker given instructions in the way the work is to be done (exclusive of actual training in 3a)? ☐ Yes ☐ No

If "Yes," give specific examples.

c Attach samples of any written instructions or procedures.

d Does the firm have the right to change the methods used by the worker or direct that person on how to do the work? ☐ Yes ☐ No

Explain your answer

e Does the operation of the firm's business require that the worker be supervised or controlled in the performance of the service? ☐ Yes ☐ No

Explain your answer

4a The firm engages the worker:

☐ To perform and complete a particular job only

☐ To work at a job for an indefinite period of time

☐ Other (explain)

b Is the worker required to follow a routine or a schedule established by the firm? ☐ Yes ☐ No

If "Yes," what is the routine or schedule?

c Does the worker report to the firm or its representative? ☐ Yes ☐ No

If "Yes": How often?

For what purpose?

In what manner (in person, in writing, by telephone, etc.)?

Attach copies of report forms used in reporting to the firm.

d Does the worker furnish a time record to the firm? ☐ Yes ☐ No

If "Yes," attach copies of time records.

5a State the kind and value of tools, equipment, supplies, and materials furnished by:

The firm

The worker

b What expenses are incurred by the worker in the performance of services for the firm?

c Does the firm reimburse the worker for any expenses? ☐ Yes ☐ No

If "Yes," specify the reimbursed expenses

6a Will the worker perform the services personally? ☐ Yes ☐ No

b Does the worker have helpers? ☐ Yes ☐ No

If "Yes": Who hires the helpers? ☐ Firm ☐ Worker

If hired by the worker, is the firm's approval necessary? ☐ Yes ☐ No

Who pays the helpers? ☐ Firm ☐ Worker

Are social security and Medicare taxes and Federal income tax withheld from the helpers' wages? ☐ Yes ☐ No

If "Yes": Who reports and pays these taxes? ☐ Firm ☐ Worker

Who reports the helpers' incomes to the Internal Revenue Service? ☐ Firm ☐ Worker

If the worker pays the helpers, does the firm repay the worker? ☐ Yes ☐ No

What services do the helpers perform?

7 At what location are the services performed? ☐ Firm's ☐ Worker's ☐ Other (specify) .....

8a Type of pay worker receives:
☐ Salary ☐ Commission ☐ Hourly wage ☐ Piecework ☐ Lump sum ☐ Other (specify) .....

b Does the firm guarantee a minimum amount of pay to the worker? ☐ Yes ☐ No

c Does the firm allow the worker a drawing account or advances against pay? ☐ Yes ☐ No
If "Yes": Is the worker paid such advances on a regular basis? ☐ Yes ☐ No

d How does the worker repay such advances? .....

9a Is the worker eligible for a pension, bonus, paid vacations, sick pay, etc.? ☐ Yes ☐ No
If "Yes," specify .....

b Does the firm carry workmen's compensation insurance on the worker? ☐ Yes ☐ No

c Does the firm deduct social security and Medicare taxes from amounts paid the worker? ☐ Yes ☐ No

d Does the firm deduct Federal income taxes from amounts paid the worker? ☐ Yes ☐ No

e How does the firm report the worker's income to the Internal Revenue Service?
☐ Form W-2 ☐ Form 1099-MISC ☐ Does not report ☐ Other (specify) .....
Attach a copy.

f Does the firm bond the worker? ☐ Yes ☐ No

10a Approximately how many hours a day does the worker perform services for the firm? .....
Does the firm set hours of work for the worker? ☐ Yes ☐ No
If "Yes," what are the worker's set hours? _____ am/pm to _____ am/pm (Circle whether am or pm)

b Does the worker perform similar services for others? ☐ Yes ☐ No ☐ Unknown
If "Yes": Are these services performed on a daily basis for other firms? ☐ Yes ☐ No ☐ Unknown
Percentage of time spent in performing these services for:
This firm ..... % Other firms ..... % ☐ Unknown
Does the firm have priority on the worker's time? ☐ Yes ☐ No
If "No," explain .....

c Is the worker prohibited from competing with the firm either while performing services or during any later period? ☐ Yes ☐ No

11a Can the firm discharge the worker at any time without incurring a liability? ☐ Yes ☐ No
If "No," explain .....

b Can the worker terminate the services at any time without incurring a liability? ☐ Yes ☐ No
If "No," explain .....

12a Does the worker perform services for the firm under:
☐ The firm's business name ☐ The worker's own business name ☐ Other (specify) .....

b Does the worker advertise or maintain a business listing in the telephone directory, a trade journal, etc.? ☐ Yes ☐ No ☐ Unknown
If "Yes," specify .....

c Does the worker represent himself or herself to the public as being in business to perform the same or similar services? ☐ Yes ☐ No ☐ Unknown
If "Yes," how? .....

d Does the worker have his or her own shop or office? ☐ Yes ☐ No ☐ Unknown
If "Yes," where? .....

e Does the firm represent the worker as an employee of the firm to its customers? ☐ Yes ☐ No
If "No," how is the worker represented? .....

f How did the firm learn of the worker's services? .....

13 Is a license necessary for the work? ☐ Yes ☐ No ☐ Unknown
If "Yes," what kind of license is required? .....
By whom is it issued? .....
By whom is the license fee paid? .....

14 Does the worker have a financial investment in a business related to the services performed? ☐ Yes ☐ No ☐ Unknown
If "Yes," specify and give amounts of the investment .....

15 Can the worker incur a loss in the performance of the service for the firm? ☐ Yes ☐ No
If "Yes," how? .....

16a Has any other government agency ruled on the status of the firm's workers? ☐ Yes ☐ No
If "Yes," attach a copy of the ruling.

b Is the same issue being considered by any IRS office in connection with the audit of the worker's tax return or the firm's tax return, or has it recently been considered? ☐ Yes ☐ No
If "Yes," for which year(s)?

(continued on next page)

Form SS-8 (Rev. 7-93) Page 4

17 Does the worker assemble or process a product at home or away from the firm's place of business? ☐ Yes ☐ No
If "Yes":
Who furnishes materials or goods used by the worker? ☐ Firm ☐ Worker
Is the worker furnished a pattern or given instructions to follow in making the product? ☐ Yes ☐ No
Is the worker required to return the finished product to the firm or to someone designated by the firm? ☐ Yes ☐ No

Answer items 18a through n only if the worker is a salesperson or provides a service directly to customers.

18a Are leads to prospective customers furnished by the firm? ☐ Yes ☐ No ☐ Does not apply
b Is the worker required to pursue or report on leads? ☐ Yes ☐ No ☐ Does not apply
c Is the worker required to adhere to prices, terms, and conditions of sale established by the firm? ☐ Yes ☐ No
d Are orders submitted to and subject to approval by the firm? ☐ Yes ☐ No
e Is the worker expected to attend sales meetings? ☐ Yes ☐ No
If "Yes": Is the worker subject to any kind of penalty for failing to attend? ☐ Yes ☐ No
f Does the firm assign a specific territory to the worker? ☐ Yes ☐ No ☐ Does not apply
g Who does the customer pay? ☐ Firm ☐ Worker
If worker, does the worker remit the total amount to the firm? ☐ Yes ☐ No
h Does the worker sell a consumer product in a home or establishment other than a permanent retail establishment? ☐ Yes ☐ No
i List the products and/or services distributed by the worker, such as meat, vegetables, fruit, bakery products, beverages (other than milk), or laundry or dry cleaning services. If more than one type of product and/or service is distributed, specify the principal one.
j Did the firm or another person assign the route or territory and a list of customers to the worker? ☐ Yes ☐ No
If "Yes," enter the name and job title of the person who made the assignment.
k Did the worker pay the firm or person for the privilege of serving customers on the route or in the territory? ☐ Yes ☐ No
If "Yes," how much did the worker pay (not including any amount paid for a truck or racks, etc.)? $
What factors were considered in determining the value of the route or territory?
l How are new customers obtained by the worker? Explain fully, showing whether the new customers called the firm for service, were solicited by the worker, or both.
m Does the worker sell life insurance? ☐ Yes ☐ No
If "Yes":
Is the selling of life insurance or annuity contracts for the firm the worker's entire business activity? ☐ Yes ☐ No
If "No," list the other business activities and the amount of time spent on them
Does the worker sell other types of insurance for the firm? ☐ Yes ☐ No
If "Yes," state the percentage of the worker's total working time spent in selling other types of insurance %
At the time the contract was entered into between the firm and the worker, was it their intention that the worker sell life insurance for the firm: ☐ on a full-time basis ☐ on a part-time basis
State the manner in which the intention was expressed.
n Is the worker a traveling or city salesperson? ☐ Yes ☐ No
If "Yes": From whom does worker principally solicit orders for the firm?
If the worker solicits orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments, specify the percentage of the worker's time spent in this solicitation. %
Is the merchandise purchased by the customers for resale or for use in their business operations? If used by the customers in their business operations, describe the merchandise and state whether it is equipment installed on their premises or a consumable supply.

19 Attach a detailed explanation of any other reason why you believe the worker is an independent contractor or is an employee of the firm.

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented are true, correct, and complete.

Signature ▶ Title ▶ Date ▶

If this form is used by the firm in requesting a written determination, the form must be signed by an officer or member of the firm.
If this form is used by the worker in requesting a written determination, the form must be signed by the worker. If the worker wants a written determination about services performed for two or more firms, a separate form must be completed and signed for each firm.
Additional copies of this form may be obtained from any Internal Revenue Service office or by calling 1-800-TAX-FORM (1-800-829-3676).

*U.S. Government Printing Office: 1994 — 301-628/00158

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SCHEDULE SE (Form 1040)

Department of the Treasury Internal Revenue Service (O)

Self-Employment Tax

▶ See Instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

OMB No. 1545-0074

1993

Attachment Sequence No. 17

Name of person with **self-employment** income (as shown on Form 1040) | Social security number of person with **self-employment** income ▶

Who Must File Schedule SE

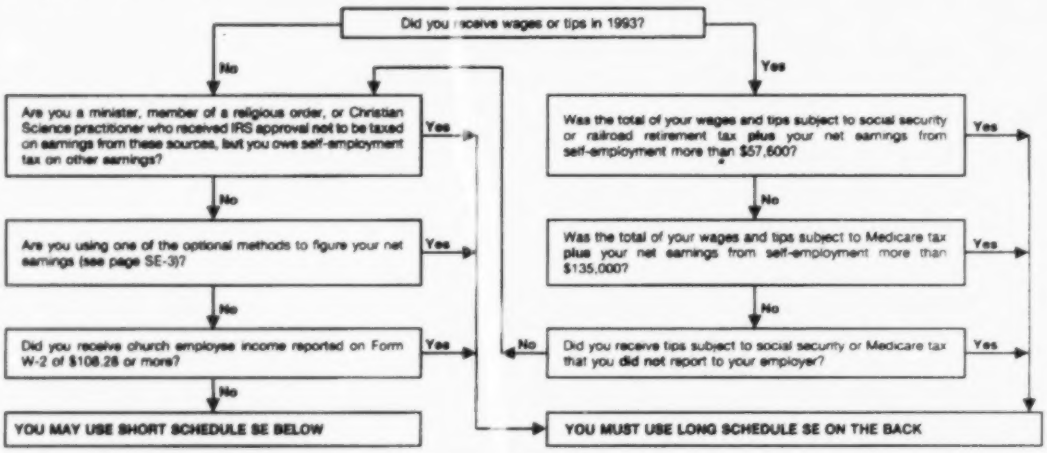
You must file Schedule SE if:

- Your wages (and tips) subject to social security AND Medicare tax (or railroad retirement tax) were less than $135,000; **AND**
- Your net earnings from self-employment from other than church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) were $400 or more; **OR**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note: *Even if you have a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.*

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner, **AND** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **DO NOT** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 47.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?


Did you receive wages or tips in 1993?
No
Yes
Are you a minister, member of a religious order, or Christian Science practitioner who received IRS approval not to be taxed on earnings from these sources, but you owe self-employment tax on other earnings?
Yes
No
Are you using one of the optional methods to figure your net earnings (see page SE-3)?
Yes
No
Did you receive church employee income reported on Form W-2 of $108.28 or more?
Yes
No
YOU MAY USE SHORT SCHEDULE SE BELOW
Was the total of your wages and tips subject to social security or railroad retirement tax plus your net earnings from self-employment more than $57,600?
Yes
No
Was the total of your wages and tips subject to Medicare tax plus your net earnings from self-employment more than $135,000?
Yes
No
Did you receive tips subject to social security or Medicare tax that you did not report to your employer?
Yes
No
YOU MUST USE LONG SCHEDULE SE ON THE BACK

Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	
3	Combine lines 1 and 2	3	
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	
5	**Self-employment tax.** If the amount on line 4 is: • $57,600 or less, multiply line 4 by 15.3% (.153) and enter the result. • More than $57,600 but less than $135,000, multiply the amount in excess of $57,600 by 2.9% (.029). Then, add $8,812.80 to the result and enter the total. • $135,000 or more, enter $11,057.40. Also enter on **Form 1040, line 47. (Important:** You are allowed a deduction for **one-half** of this amount. Multiply line 5 by 50% (.5) and enter the result on **Form 1040, line 25.)**	5	

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1993**

(continued on next page) 251

Schedule SE (Form 1040) 1993 — Attachment Sequence No. 17 — Page 2

Name of person with **self-employment** income (as shown on Form 1040) | Social security number of person with **self-employment** income ▶

Section B—Long Schedule SE

Part I Self-Employment Tax

Note: *If your only income subject to self-employment tax is church employee income, skip lines 1 through 4b. Enter -0- on line 4c and go to line 5a. Income from services you performed as a minister or a member of a religious order is not church employee income. See page SE-1.*

A If you are a minister, member of a religious order, or Christian Science practitioner **AND** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I . . . . . ▶ ☐

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a. **Note:** *Skip this line if you use the farm optional method. See page SE-3*		1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report. **Note:** *Skip this line if you use the nonfarm optional method. See page SE-3*		2	
3	Combine lines 1 and 2		3	
4a	If line 3 is more than zero, multiply line 3 by 92.35% (.9235). Otherwise, enter amount from line 3		4a	
b	If you elected one or both of the optional methods, enter the total of lines 17 and 19 here		4b	
c	Combine lines 4a and 4b. If less than $400, **do not** file this schedule; you do not owe self-employment tax. **Exception.** If less than $400 and you had church employee income, enter -0- and continue ▶		4c	
5a	Enter your church employee income from Form W-2. **Caution:** *See page SE-1 for definition of church employee income*	5a		
b	Multiply line 5a by 92.35% (.9235). If less than $100, enter -0-		5b	
6	**Net earnings from self-employment.** Add lines 4c and 5b		6	
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 1993		7	57,600 00
8a	Total social security wages and tips (from Form(s) W-2) and railroad retirement (tier 1) compensation	8a		
b	Unreported tips subject to social security tax (from Form 4137, line 9)	8b		
c	Add lines 8a and 8b		8c	
9	Subtract line 8c from line 7. If zero or less, enter -0- here and on line 10 and go to line 12a ▶		9	
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (.124)		10	
11	Maximum amount of combined wages and self-employment earnings subject to Medicare tax or the 1.45% portion of the 7.65% railroad retirement (tier 1) tax for 1993		11	135,000 00
12a	Total Medicare wages and tips (from Form(s) W-2) and railroad retirement (tier 1) compensation	12a		
b	Unreported tips subject to Medicare tax (from Form 4137, line 14)	12b		
c	Add lines 12a and 12b		12c	
13	Subtract line 12c from line 11. If zero or less, enter -0- here and on line 14 and go to line 15		13	
14	Multiply the **smaller** of line 6 or line 13 by 2.9% (.029)		14	
15	**Self-employment tax.** Add lines 10 and 14. Enter here and on **Form 1040, line 47. (Important:** You are allowed a deduction for **one-half** of this amount. Multiply line 15 by 50% (.5) and enter the result on **Form 1040, line 25.)**		15	

Part II Optional Methods To Figure Net Earnings (See page SE-3.)

Farm Optional Method. You may use this method **only** if **(a)** Your gross farm income[1] was not more than $2,400 **or (b)** Your gross farm income[1] was more than $2,400 and your net farm profits[2] were less than $1,733.

16	Maximum income for optional methods		16	1,600 00
17	Enter the **smaller** of: two-thirds (⅔) of gross farm income[1] (not less than zero) **or** $1,600. Also, include this amount on line 4b above		17	

Nonfarm Optional Method. You may use this method **only** if **(a)** Your net nonfarm profits[3] were less than $1,733 and also less than 72.189% of your gross nonfarm income,[4] **and (b)** You had net earnings from self-employment of at least $400 in 2 of the prior 3 years. **Caution:** *You may use this method no more than five times.*

18	Subtract line 17 from line 16		18	
19	Enter the **smaller** of: two-thirds (⅔) of gross nonfarm income[4] (not less than zero) **or** the amount on line 18. Also, include this amount on line 4b above		19	

[1] From Schedule F, line 11, and Schedule K-1 (Form 1065), line 15b.
[2] From Schedule F, line 36, and Schedule K-1 (Form 1065), line 15a.
[3] From Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a.
[4] From Schedule C, line 7; Schedule C-EZ, line 1; and Schedule K-1 (Form 1065), line 15c.

*U.S.GPO:1993-0-345-219

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1994 Estimated Tax Worksheet (keep for your records)

1	Enter amount of adjusted gross income you expect in 1994 (see instructions)	1	
2	• If you plan to itemize deductions, enter the estimated total of your itemized deductions. **Caution:** If line 1 above is over $111,800 ($55,900 if married filing separately), your deduction may be reduced. See Pub. 505 for details. • If you do not plan to itemize deductions, see **Standard Deduction for 1994** on page 2, and enter your standard deduction here.	2	
3	Subtract line 2 from line 1	3	
4	Exemptions. Multiply $2,450 by the number of personal exemptions. If you can be claimed as a dependent on another person's 1994 return, your personal exemption is not allowed. **Caution:** If line 1 above is over $167,700 ($139,750 if head of household; $111,800 if single; $83,850 if married filing separately), get Pub. 505 to figure the amount to enter	4	
5	Subtract line 4 from line 3	5	
6	**Tax.** Figure your tax on the amount on line 5 by using the 1994 Tax Rate Schedules on page 2. DO NOT use the Tax Table or the Tax Rate Schedules in the 1993 Form 1040 or Form 1040A instructions. **Caution:** If you have a net capital gain and line 5 is over $91,850 ($78,700 if head of household; $55,100 if single; $45,925 if married filing separately), get Pub. 505 to figure the tax	6	
7	Additional taxes (see instructions)	7	
8	Add lines 6 and 7	8	
9	Credits (see instructions). Do not include any income tax withholding on this line	9	
10	Subtract line 9 from line 8. Enter the result, but not less than zero	10	
11	Self-employment tax. Estimate of 1994 net earnings from self-employment $ _____ if **$60,600 or less,** multiply the amount by 15.3%; if **more than $60,600,** multiply the amount in excess of $60,600 by 2.9%. Add $9,271.80 to the result and enter the total. **Caution:** If you also have wages subject to social security tax, get Pub. 505 to figure the amount to enter	11	
12	Other taxes (see instructions)	12	
13a	Add lines 10 through 12	13a	
b	Earned income credit and credit from **Form 4136**	13b	
c	Subtract line 13b from line 13a. Enter the result, but not less than zero. **THIS IS YOUR TOTAL 1994 ESTIMATED TAX** ▶	13c	
14a	Multiply line 13c by 90% (66⅔% for farmers and fishermen)	14a	
b	Enter 100% of the tax shown on your 1993 tax return (110% of that amount if you are not a farmer or a fisherman and the adjusted gross income shown on that return is more than $150,000 or, if married filing separately for 1994, more than $75,000)	14b	
c	Enter the **smaller** of line 14a or 14b. **THIS IS YOUR REQUIRED ANNUAL PAYMENT TO AVOID A PENALTY** ▶ **Caution:** Generally, if you do not prepay (through income tax withholding and estimated tax payments) at least the amount on line 14c, you may owe a penalty for not paying enough estimated tax. To avoid a penalty, make sure your estimate on line 13c is as accurate as possible. Even if you pay the required annual payment, you may still owe tax when you file your return. If you prefer, you may pay the amount shown on line 13c. For more details, get Pub. 505.	14c	
15	Income tax withheld and estimated to be withheld during 1994 (including income tax withholding on pensions, annuities, certain deferred income, etc.)	15	
16	Subtract line 15 from line 14c. (**Note:** *If zero or less, or line 13c minus line 15 is less than $500, stop here. You are not required to make estimated tax payments.*)	16	
17	If the first payment you are required to make is due April 15, 1994, enter ¼ of line 16 (minus any 1993 overpayment that you are applying to this installment) here and on your payment voucher(s)	17	

These definitions apply only to this text and are simplified to suit that purpose. For complete definitions in other contexts, please consult a complete dictionary.

Accessible – Can be entered and exited readily.

Accounting – Recording, classifying, analyzing, interpreting, summarizing, and reporting financial transactions.

Accounts receivable – Money owed the business.

Accrual method – Expenses are recognized when obligated and income when the sale is made, regardless of when the payments are made.

Accrue – Accumulate.

Added value – A product is changed or improved for resale at a higher price.

Adversarial relationship – Opposing.

Advertising plan – An organized plan for promotion.

Advertising specialties – "Freebies" or giveaway items to promote your business.

Advertising – Paid promotion of your product or service.

Allocated costs – Costs of which a proportional share are assigned to given products or services. Indirect costs are allocated when pricing the product or service and thus, are referred to as allocated costs.

Americans with Disabilities Act – Act providing equal access and opportunity for all Americans.

Anchor store – A major retailer, usually located at the end of a shopping mall; major department store.

Annual percentage rate (APR) – The annualized percentage rate of the finance charge.

Application – Request for consideration.

Articles of incorporation – Written items describing the purpose and organization of the corporation.

Articulate – Able to speak effectively.

Asset accounts – Accounts which record transactions of "things" (such as cash, land, receivables, buildings, and similar items) owned by the business.

Attainable – Can be achieved.

Audit – Exacting examination of the records.

Bad debt – A debt that is considered uncollectible.

Balance sheet – A financial report summarizing a business' financial condition categorized by assets, liabilities, and the owner's equity at a given point in time.

Bank cards – Credit cards issued by banks allowing customers to purchase items on credit. The bookkeeping and billing is completed by the banks for a percentage of the sale amount.

Basic accounting equation – Assets minus liabilities equals net worth *or* assets equals liabilities plus net worth.

Bookkeeping – Systematically classifying and recording business financial transactions and events.

Bottom line – Profit.

Break of the scale – The amounts between five-pound intervals.

Budget – Careful analysis of anticipated income and expenses.

Business entity – The business as it exists separate from its owners.

Business ethics – Standard of conduct for operating the business.

Business plan – A detailed written plan for operating a business enterprise or venture.

Business ratios – A way of comparing business items, a shortcut way to determine if additional information is needed.

Business – An entity created, organized, and conducted to make a profit.

Bylaws – Written guidelines for the operation of the organization.

Capital equipment list – Record of depreciable equipment.

Capital – Money invested in the business.

Cash flow – The difference between cash coming into and going out of a business enterprise over a certain time period.

Cash flow budgeting – Estimating the income and expenses for a given time period.

Cash flow crisis – Expenses exceeding cash on hand.

Cash method – Income and expenses recognized at payment.

Center of interest – The main feature of the exhibit.

Challenging – Requires special effort.

Chamber of Commerce – Nonprofit entity designed to promote local community activities and business.

Chart of accounts – A list of asset, liability, net worth, revenue, and expense accounts maintained in the company's books.

Collateral – Property pledged as security for a loan.

Collection agency – Organization that collects debts for a fee.

Collections – Obtaining payment of amounts due.

Competitive advantage – Anything that permits you to maintain or improve your share of the market such as location, lower costs, better quality, or service.

Competitor – A business that sells the same or similar products.

Complemented – Added to, or completed a whole.

Consignment – Supplied with the payment to be made when sold.

Consumption – To use up.

Contract – The type of sale agreement in which the asset ownership does not change until payments are completed.

Conviction – Being certain of the right.

Cost benefit ratio – Costs as compared to returns.

Cost competitive – Cost of a product is below a competitor's.

Cost of goods sold – The total of direct costs.

Cost of sales – A subheading on the income statement which identifies the direct costs of products or services sold.

Cost – The money you pay for materials, labor hired, money borrowed, and overhead expenses to make the product you sell in your business.

Counseling – One-on-one advice to small business owners.

Coverage – The specific perils insured against.

Credit application – Written information gathered on a form to make the credit-granting decision.

Credit Bureau – Organization providing credit information to businesses for a fee.

Credit policy – Rules indicating when to grant credit.

Credit rating – Estimation of repayment ability for a business or individual.

Credit – Entry in the right-hand column that increases a liability, net worth, or revenue account or decreases an asset or expense account; obtaining goods or services on the basis of deferred payment.

Creditor – Entity owed.

Criteria – Measure of value; specific standards to measure by.

Current ratio – A business ratio based on current assets and current liabilities.

Customer profile – Demographic information about customers.

Debit – Entry in the left-hand column that increases an asset or expense account or decreases a liability, net worth, or revenue account.

Debt financing – Borrowing money to operate or to purchase equipment.

Debt service ratio – Business ratio based on the percentage of income dedicated to debt payment.

Deductible – The amount the insured pays in case of a loss.

Degree of solvency – Business ratio dealing with liquidity.

Demand – A schedule of the amounts of goods or services that customers are willing to buy at given prices.

Demand shifters – Things that change the amount of goods or services customers will buy at a given price.

Demographics – Detailed information about the people in the area.

Destination trips – Shopping trips to a particular store such as for groceries.

Direct costs – Costs that can be traced directly to and are caused by the product or service.

Document – Provide necessary verification or proof.

Doers – People who accomplish things.

Double-entry – A method of recording the debits and credits of a business transaction or financial event in a journal and a ledger; the sum of all debits numerically equals the sum of all credits.

Dreamers – People who have big ideas, but never do them.

Durable goods – Items likely to have resale value.

Elastic demand – When a change in price makes a big difference in the quantity that customers are willing and able to buy.

Endorsement – A special clause added to an insurance policy to cover certain perils.

Entity – Something that exists independently.

Entrepreneur – One who takes the risks of starting and operating a business.

Environmental Protection Act – Law to protect the environment.

Equity – Degree of ownership.

Equity financing – Money provided by owners that has not been loaned to a business.

Equity funds – Funds generated by ownership in the business.

Event – A change within the business, such as completing goods for sale; accounting entry to recognize a value change between two or more accounts within the business.

Exclusions – Things excluded from the coverage.

Exhibitors – Companies or persons promoting products at a show or fair.

Expansion – Enlarging the business through various means.

Expectations – Anticipated results.

Expenses – An accounting term for cost; a subheading on the income statement which identifies indirect costs.

Feasibility – Checks the possible profitability of a proposed decision.

Feature story – A news story about a particular item or person.

Finance – The money invested in, or used and earned by a business.

Financial statement – Collection of financial reports consisting of at least a balance sheet and income statement, but often including a cash flow statement and sometimes detailed notes and other descriptive comments.

Fixed costs – Costs that do not vary with volume of sales or production.

Foot traffic – Number of people who pass by the location.

Franchise – A business that pays a fee for using the parent company's logos, supplies, and management help.

From scratch – A start from nothing.

Full cost – The total cost to produce a good or service which includes all direct costs and a proportionate share of indirect costs.

Goals – Things we strive to achieve.

Gross profit – The calculated difference between sales and cost of sales.

Home-based – Operated from the home.

Homeowners – An insurance policy to protect private homeowners.

Horticulture – Study of the science of growing fruits, flowers, or shrubs.

Immediate goal – Something to achieve this year.

Incentive – Inducement for superior performance.

Income statement – A report summarizing the revenue and expense transactions for a period between two balance sheet reports. (Sometimes called a profit and loss statement or a P & L.)

Income tax – State or federal tax on personal income.

Indirect costs – Costs that cannot be traced to a specific product or service. When pricing the product, good, or service, these costs must be allocated. Often referred to as overhead costs, general and administrative costs, operating expenses, and similar items on the income statement.

Individual entity – You or I as an individual.

Inelastic demand – When a change in price makes little or no difference in the quantity that customers are willing and able to buy.

Inferential data – Assumptions based on other data or observations.

Installment credit – Credit for a particular transaction to be paid in installments.

Insurance – The risk of loss is assumed by the insurance company for a premium.

Interview – Personal conversation to determine a hiring decision.

Inventory – Listing of resources.

Job description – Listing of qualifications or skills for a given job.

Journal – The book of original entry used to record, usually in chronological order, each business and/or financial transaction and event of the business.

Labor costs – The total cost of the labor to produce a product or service. Includes such items as hourly wage; fringe benefits; social security, Medicare and unemployment contributions; and insurance such as worker compensation or public liability and property damage when such insurance is tied to the payroll.

Labor intensive – A product or service that uses much labor and not much money.

Leasing – Renting assets instead of purchasing them, this allows more capital to be used in other resources.

Ledger – The book used to record or "post" each transaction and event recorded in the journal to individual accounts as a credit or debit.

Liability accounts – Accounts in which amounts owed by the business are recorded (such as payables, loans, and similar items).

Liability insurance – Insurance against any liability arising from given activity.

License – A fee paid to operate a certain business.

Lien rights – Claim against assets of the company.

Lien – Monetary claim against property.

Line of credit – Borrowing arrangement which allows the use of a loan up to a given amount.

Liquid assets – Assets owned that can be readily turned into cash.

Location – Where a business is physically located.

Logo – A distinctive company symbol or trademark.

Long-term credit – Credit to be repaid in a term longer than one year.

Long-term goal – Something to achieve in a lifetime.

Low-cost producers – Producers who have lower material, labor, and overhead costs than their competitors.

Management – Business decision making.

Mark-up – An amount added to the direct cost of the product or service to include an allocated share of indirect costs and profit.

Market niche – A specifically defined portion of a market; a well-defined segment of a market.

Market penetration – The ability to gain an increasing share of a market.

Market research – Gathering information related to promotion of a given product.

Marketing plan – A plan for promoting your product or services.

Marketing – Activities to sell the product or service offered.

Material costs – The total cost of the materials used to produce the good or service.

Media kit – Materials promoting advertising in that medium.

Media – Newspapers, radio, and television are the most common media.

Mind resources – The knowledge you bring to an enterprise.

Money resources – Finances available for a business venture.

Motivation – Something physical, financial, or emotional that causes us to act.

Muscle resources – The time you can devote to an enterprise.

Net worth – Owner's equity or the value of assets in excess of the liabilities of the business.

Non-business entity – An organization such as a church, school, or other nonprofit organization.

Occupational Health and Safety Act (OSHA) – Regulates the working conditions which employers provide their employees.

Open charge – Purchases are made on credit and paid for on agreed terms, such as five percent discount if paid in ten days.

Open house – Inviting the public to see the business.

Operating capital – Funds used to maintain operations.

Operations – The day-to-day activities of the business.

Orientation – Acquainting a new employee with the job and the company.

Overhead costs – Fixed costs of doing business such as rent, utilities, or other ongoing costs.

Owner's equity – Value of the owner's share of the business.

Paid-in capital – The money invested in the business by its owners or shareholders.

Payroll taxes – Taxes deducted from a worker's pay.

Performance – Effective function with quality of work done.

Perils – Risks covered by the insurance policy.

Period report – Summary of income and expense for a given time period, such as an income tax schedule. Sometimes called an income statement or profit and loss statement.

Personnel – The people who work in the business.

Pink slip – Termination of employment.

Policy – Written details and conditions of purchased insurance.

Posting – Recording each transaction from the journal to the ledger.

Premium – Money paid for an insurance policy.

Price lining – Providing various qualities at different prices.

Primary research – Data you gather for yourself.

Private funds – Finances obtained from noncommercial sources.

Private showing – By invitation only.

Procrastination – Putting off action.

Products – Something grown, processed, or manufactured.

Profit and loss statement – A report summarizing the revenue and expense transactions for a period between two balance sheet reports.

Profit – Income above all expenses; money you earn when you sell products for more than their cost to you.

Promissory note – A signed, written promise to pay a given amount in a given time.

Promotion – Activities and events conducted to feature your product or service.

Propagating – Growing or reproducing.

Property insurance – Insurance on property to protect from fire loss and similar items.

Proprietary – Owned by the company.

Proprietor – Manager or operator.

Publicity – Bringing to the public's attention.

Purchase agreement – An agreement that lease payments apply to the purchase price.

Pure risk – Insurable risk such as a fire or tornado.

Ratify – Approve.

Ratios – Financial measures used by lenders in decision making.

Recipes – The way resources are used in the business (formulas).

Related businesses – Businesses in the same field such as car dealerships and auto parts stores.

Research – Systematic gathering of information for a specific purpose.

Resources – Labor, management, and materials used in production; mind, muscle, and money are our entrepreneurial resources.

Restructure – Today many businesses are restructuring by downsizing and reducing employee numbers.

Retained earnings – An account that reflects the accumulated profit or loss of a company since its beginning.

Revolving credit – Purchases are made on credit and payments are based on a percentage of the balance.

Risk avoidance – Avoiding the activities that cause risk.

Risk management – Selecting a risk option alternative.

Risk reduction – Using training or other methods to reduce risk.

Risk retention – Carrying the risk yourself instead of purchasing insurance.

Risk taker – One who takes risks, an entrepreneur.

Risk transfer – Purchasing insurance so the insurance company carries the risk.

Risk – A chance for profit or loss; chance of misfortune, such as loss of your capital.

Sales tax permit – Permit to collect mandatory sales taxes.

Sales tax – Tax on sales of goods or services.

SCORE – Service Corp of Retired Executives dedicated to providing advice to aspiring entrepreneurs.

Secondary research – Data gathered from existing data sources.

Self-esteem – Self-confidence.

Self-sustaining – Meeting all expenses on a current basis.

Service – Value-adding customer aid beyond just supplying goods.

Services – Providing the use of something for others.

Shareholders – Ownership of a corporation based on investment.

Sheltered – Protected from personal liability.

Shoestring – Very limited budget.

Short-term credit – Credit to be repaid within one year.

Short-term goal – Something to achieve in the next one to five years.

Single-entry – A bookkeeping system that does not record transactions explicitly with debits equal to credits (sometimes called "one-sided entries").

Small Business Administration (SBA) – Federal agency devoted to the interests of small businesses.

Small Business Development Centers (SBDC's) – Public/private partnerships to promote small businesses.

Source document – A paper form such as a check, sales slip, or a receipt which supports every accounting transaction.

Special interest – A defined group based on some common interest, for example, baseball fans.

Speculative risk – Risk of loss you accept when you invest money in your business.

Spreadsheet – Powerful computer program that can give quick answers to financial projections of varying conditions.

Standard and Poors Directory – An important business reference.

Stock shares – Partial ownership of the business.

Studio – Artist's work area

Supply – A schedule of the amounts of goods that producers are willing and able to supply to customers at given prices.

Supply shifters – Things that change the amounts of goods or services offered at a given price.

Support team – Those who lend support and aid to an entrepreneur.

Taxable – Subject to a tax.

Taxes – Money raised by levies to pay the cost of government services.

Test market – Trying out a product on a limited basis to see if it can be profitable.

Trade credit – Suppliers shipping on open account.

Trade show – Marketing aimed at a specific group.

Traffic counts – Counts of vehicles passing a given point.

Training – Preparing new employees to do the job your way.

Transaction – Financial exchange between entities.

Trial balance – A listing of all accounts in the chart of accounts, along with the balance of each account, at the end of the normal accounting period.

Trust fund taxes – Withholding taxes collected from employee wages.

Truth-in-Lending laws – Consumer protection laws requiring the full disclosure of terms in a credit sale.

Uniform Commercial Code – Regulates sales between merchants.

Value added – Changing a product into another of higher value – e.g., milk into ice cream.

Variable costs – Costs that vary with production or sales.

Venture capitalist – Investor who makes a business of funding new businesses.

Vested – Having met the requirements for permanent participation in the plan.

Visibility – Easily seen or prominent.

Warranties – Sale of goods sometimes gives implied guarantees.

Withholding – Payroll taxes.

Word of mouth – One person telling another; from one individual to another.

Zoning laws – Laws regulating location of certain types of businesses.

Zoning ordinances – Laws restricting certain business locations.

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